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Introduction

Real Estate Finance is part of the **first tuesday** series of California-specific real estate study materials. Each title in the series has a different topic as its primary content. As part of a comprehensive real estate education program, the series includes Principles of Real Estate, Real Estate Practice, Legal Aspects of Real Estate and Real Estate Property Management.

first tuesday's real estate series uses plain language and eliminates the extensive overlap of identical course material commonly offered by other publishers. Issues arising in more than one factual setting are referenced as necessary, but are dealt with fully in only one **first tuesday** title.

Real Estate Finance is written for real estate licensees, lenders, attorneys, title officers, buyers and sellers. This course material is designed to be an educational tool for use in the classroom and as a technical research and reference tool on mortgage law in California. The scope of the materials presented extends beyond a minimum acceptable level of knowledge and professional development.

The objective of this material is to fully develop the real estate professional's knowledge of the historical relationship between lenders and borrowers and the rights and obligations arising out of debts secured by real estate. **Real Estate Finance** also discusses notes, trust deeds and other security devices, as well as their provisions and foreclosure procedures. Also analyzed in this material is carryback financing, private money lending by individuals and the sale and assignment of trust deeds.

Included, with an explanation for their use, are all the forms and notices required to establish and disclose real estate loan arrangements, to create and document an installment sale of real estate by a carryback seller, and to enforce or defend against foreclosure. Forms are treated as itemized check lists of disclosures by an agent and reviewed with buyers and sellers of real estate.

These forms fully reflect relevant codes, regulations, judicial decisions and practices in effect on the date of this publication. The forms referenced are developed and published by **first tuesday**.

SECTION A

The Borrower-Lender Relationship

Chapter 1 Pre-Wellenkamp history

This chapter presents the background for the legal and legislative resolutions to the historic conflicts between real estate owners and their lenders.

Ownership objectives were paramount

The conflicting demands for financial survival between property owners who invest in real estate for income and mortgage lenders, who invest in loans based on the value of real estate as security, collide when an owner encumbers real estate with a trust deed loan.

Owners and lenders always compete for a higher return on their investment. Their investment positions are generally in opposition to one another since they are in a "zero-sum" game. The financial return to both the owner and the lender flows from the property's *market value* and the actual or *implicit income* the property produces.

Capital growth and a return on the equity are the owner's objectives. Lenders seek an interest income yield, payable either out of the property's rental income or the value of the owner's personal or business use of the property, called *implicit rent*. Pursuit of these goals often involves a degree of confrontation and economic violence.

Owners risk their invested money in the expectation of a return and to hedge against the constantly diminishing purchasing power of the dollar. However, lenders share this same risk.

The return expected by an owner from his property is based on his forecast of the effect the general and local economy will have on the value of the property.

If the owner's choice of location, the price he pays and the timing of his acquisition is favorable, his invested capital will increase in value due to general price inflation and possible human appreciation. In real estate, the owner has a **useful hedge** against the continued deterioration of the dollar's purchasing power, called *inflation*.

Owners are also placed at risk for the **time and effort** invested in locating suitable real estate and managing the maintenance and enhancement of their investment. Owners of real estate typically take an active role in its maintenance, looking after their property on a daily basis. Thus, while the owner is protecting his investment, the lender's security interest and investment returns are protected at the same time.

Lender objectives

Lenders avoid the ownership risks and liability exposure accompanying the care and maintenance of property. Mortgage lenders are *portfolio investors*, uninvolved in the activities of managing the real estate which secures repayment of their loan and produces income to provide a return on the funds they lent to the owner.

Mortgage lenders seek lending opportunities on properties in locations where they feel properties will hold their value. When originating loans, lenders try to reduce their exposure to the risks inherent in real estate investments, such as the depreciation of property due to a depressed or recessionary local economy.

However, the favorable movement of a property's value and income flow is precisely what an investor who owns real estate is gambling on.

A lender takes care to avoid becoming the owner of the secured property as a consequence for having made a loan. While the owner's investment risk is 100% of the property's value, a prudent mortgage lender takes an invested risk of only 70% or 75% of the value.

The mortgage lender's margin, called a *loan-to-value (LTV) ratio*, indicates lenders are not in the business of owning real estate. Lenders select desirable investment locations, lend amounts less than the current appraisal market value of the property, and lend only to borrowers/owners who have other substantial assets or sources of income in case of economic trouble.

Lenders favor owners with other assets to cover the risk of the secured property value falling below the loan balance. A deficiency in the value of the secured property to cover the amount of the loan is foremost in lenders' minds.

Lenders want a return on their investment based on the current rate at which they can lend, or rent, their money. No mortgage lender formulates its rate of return (*interest income*) on the annual rental income the secured property will produce, actual or implicit. To do so would base the lenders' earnings and wealth on both the property's current market value, and on the effect of the future strength or weakness in the general and local economies on rental income.

Only when stuck with foreclosed properties do lenders succumb to the pressures of the real estate market for a return on what remains of their investment gone bad.

Lenders vs. owners

The positions, goals and anticipations of the lender and the owner of real estate are diametrically opposed.

This **adversarial relationship** stems partly from greed, an entrepreneurial trait which is generally what brings both parties to a property in the first place.

California Supreme Court decisions in the 1960s and 1970s brought the confrontation between lenders and owners into sharp focus, as did antideficiency legislation in the 1930s.

Property owners took one case after another of lender injustices to the courts, challenging the right of lenders to flex their due-on-sale muscles by raising interest rates at will when the owner of a parcel of real estate encumbered by a loan needed to sell, or by taking insurance proceeds and applying them to the loan balance at will.

Before litigation slowed in the mid-1980s, two decades of judicial favor had come and gone for owners of real estate as litigation and deregulation were rearranging priorities in the economy.

To understand the cause of the ongoing lender- versus-owner battles, a review of the events in the 1960s and the 1970s is necessary. Important factors included the shifting control of the marketplace from lender to owner, then back again to lender, and the often conflicting national and California economies, while the case law developed into the early 1980s.

The early '60s: a stable market

No shocking economic events occurred between 1960 and 1965 for owners and lenders. General prosperity reigned and relative satisfaction with real estate interests existed among most owners and lenders. However, the recurring cycle of tight money contributed to the real estate recession of 1965 through 1967.

In between the 1958 and 1965 recessionary dips in the California real estate economy, the savings and loan associations (S&Ls) in Southern California fell into what became for them the disastrous period of the 1963-64 economic boom.

A massive inflow of funds to be lent on real estate forced the S&Ls, who were only staffed for a minimal steady flow of funds and investment lending, to rely on new inexperienced staff and the brokerage industry to place the funds.

Lenders paid commissions and points to real estate brokers who procured or referred borrowers to them. The construction industry verged on hysteria at this abundance of funds. Anyone, it was then said, could use the back of an old envelope to sketch a building plan and obtain a lender's "horseback" commitment for a construction loan — and close on it!

Credit was secondary. The lender's objective was to get the funds out. Interest earnings and short-term profits, called *points* and *dutch interest* (18- month prepaid), were the major concern.

Lenders frankly viewed the excess money as lettuce about to rot on the shelf. Money had to be moved. As a result, lenders chased deals to place the funds, a classic prelude to investment error for lenders and investors.

Broker control during the early '60s

In an environment of excess private investment and abundant loan funds, brokers and owners usually control the market.

In the early 1960s, builders and buyers picked and chose projects and properties with little concern over the availability of loan funds. Funds were advanced for the asking, the interest rate was below 7%, and inflation was lower.

Builders overbuilt and by 1966, vacancy rates and foreclosures soared. Lenders had lent and sellers had sold to unqualified borrowers and buyers, causing defaults and increasing foreclosure rates. Brokers did their job of rendering the services which brought the different parties together.

Suddenly, the real estate industry, having grown too fast due to the lack of financial safeguards on the lenders, became mired in its own excesses.

By the late 1960s, lenders started looking for ways to protect themselves, and, with governmental administrative assistance in mergers, regained control of their investments.

Lenders begin massing forces

At the time, a case handed down by the California Supreme Court went generally unnoticed. The first in a continuing series of cases relating to the lender's use of the *due-on clause* in their trust deeds, the court modified common law's rigid interpretation and application of the **due-on clause**. [**Coast Bank** v. **Minderhout** (1964) 61 C2d 311]

Common law had rendered due-on clauses absolutely **void and unenforceable**. The due-on clause, simply put, was a restraint on the free use of any ownership interest. In *Coast Bank*, a more permissive reasonable enforcement (use) of the due-on clause by lenders was judicially injected into the law of restraints on alienation. [Calif. Civil Code § 711]

As a result of the new **reasonable enforcement** test, the lower courts and the lenders' attorneys began carving out purposes for a lender's use of the clause which might be considered *commercially reasonable*, under the circumstances surrounding the note and trust deed.

If reasonable circumstances existed to justify lender's calling of a loan, then the clause could be enforced by a demand for payoff, increased rates or foreclosure if the demand was not met.

Coast Bank had no immediate influence on the real estate market of the early 1960s, since most lenders were not using the due-on clause to improve their profits and maintain their portfolio yields.

Real estate professionals in the early 1960s paid little attention to the presence of the due-on clause in trust deeds.

The late '60s: Marketplace instability

In 1965, the money supply tightened, interest rates increased, availability of mortgage funds significantly decreased and inflation started to soar.

What occurred was entirely due to governmental expenditures unrelated to the general economy; the prime culprit being the Vietnam conflict and the related industrial buildup for the war effort.

Portfolio lenders did not foresee the massive inflation which would adversely affect their fixed-rate portfolios of 30-year loans.

Almost a quarter of all the savings and loan associations (S&Ls) in California were in serious financial turmoil. The S&Ls had lent on anything to everyone, and had done so at rates which did not adequately cover the risk of inflation.

The result was property foreclosures by the thousands — and by entire tracts — as well as the collapse of a large number of large California-based S&Ls.

Real estate owned (REO) became common jargon of the real estate broker. Lenders acquired property in foreclosure which had to be sold, and lender insolvency ran rampant. Thus, merger upon merger occurred.

Most often, mergers were induced by governmental administrative pressure (and money) to keep weak lenders from going under or being taken over at greater expense to the government.

As a result, the big got bigger.

Added to this marketplace dilemma was the fact that real estate brokers and agents who had previously been making good (and comparatively easy) money in the early 1960s were now unable to remain in real estate as a source of livelihood. The industry and dwindling sales could no longer support the huge number of agents who had amassed during the boom.

As weak lenders merged into bigger, stronger lenders, the ranks of the brokerage business and the real estate trade organizations were decimated.

Lenders were the first to regroup and adjust to the changing economy, getting a head start in gaining control of the real estate marketplace. By 1968, lenders had pulled themselves together and were organized and prepared for the times ahead.

However, brokers were not so adept. Each broker had pretty much been reduced to operating alone. Little cooperation existed between brokers, and the fear of losing their remaining control over lenders and owners literally drove them apart. Franchising and the bundling of offices – mergers – as we know it today did not yet exist.

Sympathy for lenders in some courts

To top off the bad economics of the late 1960s for the non-lending, sales portion of the real estate industry, California appellate courts decided two due-on-sale cases in favor of the beleaguered lenders.

It was now reasonable for real estate lenders to use the due-on clause for profit and to adjust their portfolio yields to reflect current (higher) yields in the marketplace at the moment the owner decided to sell his property. [**Cherry** v. **Home Savings & Loan Association** (1969) 276 CA2d 574; **Hellbaum** v. **Lytton Savings and Loan Association of Northern California** (1969) 274 CA2d 456]

The reasoning of *Cherry* was repudiated by the Supreme Court two years later. [**La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864]

However, it almost took another decade for the legal confusion caused by the reasonableness doctrine of these cases, starting with the earlier *Coast Bank* case, to be put to rest judicially in *Wellenkamp* v. *Bank of America* (1978) 21 C3d 943.

During the late 1960s and until the mid-1970s, the due-on ambiguity strengthened the lender's control over the real estate industry. Without the agent first discussing an impending sale with the existing lender, no sale was allowed by a lender to be consummated unless they were paid in full or the loan was modified.

Vocabulary development geared to profit lenders

With the advent of greater-than-expected inflation and the failure of money market interest rates to return to normal within a year or so, lenders were forced to look for extra profits from less traditional sources.

Lenders developed a new vocabulary. *Non-assumable loans* and *conventional loans* became the parlance of the time period. In contrast, *assumable loans* were loans insured by the Federal Housing Administration (FHA) and the Veterans Administration (VA).

The **non-assumable loans** were required to be formally assumed and modified if taken over by a buyer of the secured property. **Assumable loans** were not required to be assumed or modified. These were only misnomers at best.

The interest rate on non-assumable loans would be increased on their assumption by a buyer to the current rate charged by the lender. Points and fees would be charged as though the loan was being newly originated. Terms of the loans were **recast and adjusted** under the due-on clause on the takeover of the loan by the buyer.

Conventional lenders were able to obtain more than the originally bargained-for fixed rate of return. Upon an owner's sale or further encumbrance of his property, lenders would interfere and exact additional profits by an adjustment, the precursor of the adjustable rate mortgage (ARM). This shift in wealth to the lenders diminished the market value and marketability of the real estate which carried the loan. Smart buyers wanted properties with FHA loans on them.

Conventional lenders achieved a dual profit role with no downside risk:

- a *floor rate*, the original fixed rate of interest; and
- an upward-only *adjusted rate* on the sale or further encumbrance of the real estate by enforcing the due-on clause.

The 1970s was certainly a dynamic decade for lenders.

Non-disclosure as the "Medovoi" syndrome

Brokers and owners fought to keep the real estate market alive. In an effort to rejuvenate sales, they developed methods to avoid the due-on clause.

Games were played to covertly transfer ownership and avoid disclosure of the transfer to the lender.

For example, brokers would have the owner transfer title to the secured property into a trust or family partnership for the owner's benefit. The lender would be advised of the action. Explanations were made, but these were hardly the reasons for the establishment of the trust or partnership vesting.

Then, without detection by the lender, the beneficial use of the trust's property would be transferred, or the ownership of the partnership would be assigned. Both transfers are off the record.

Even with recorded transfers by grant deed, lenders would not be advised. All-inclusive trust deeds (AITDs) became popular. Lenders were completely unaware of transfers as long as sellers continued to make payments and hazard insurance policies were left in place.

If the lender happened to discover the transfer through tax rolls, insurance policies or inspection of the record for transfers, buyers would attempt to avoid full disclosure. [**Medovoi** v. **American Savings and Loan Association** (1979) 89 CA3d 244 (decertified)]

Some transfer methods had built-in hazards for owners. Many sales occurred without documentation or recording. Grant deeds piled up in the safes of escrow companies and brokerage offices to someday be recorded when financial arrangements could be worked out by buyers.

This failure to record caused problems for both owners and lenders since there were too many facilitator handling payments and deeds.

The ‘70s: adjusting to inflation

It was clear inflation would run high during the 1970s. Real estate lenders needed a hard or *real rate of return* in the region of 3%, after inflation and taxes on that inflation were deducted from the interest rate they received, called the *nominal rate* or *note rate*.

Depository lenders (banks, savings and loan associations (S&Ls) and thrifts) looked for a 3% spread over their cost of funds. They were willing to net 1% on total capital assets (which includes liability for deposits).

The lenders’ risk lay in projecting a profitable annual rate of return over a 30-year period on the fixed-rate loans they held. Institutional lenders did not relish the idea of making mistakes they would have to live with for years.

Mortgage lenders seized on the due-on clause in their trust deeds to cure their miscalculations on the long-term cost of doing business. During this time, lenders retained ownership of the loans they made and had good reason to maintain yields on the loans sufficient to keep them solvent. Thus, lenders serviced the loans they made.

Any interest rate mistakes which had adverse ongoing effects on the lender’s portfolio could be remedied by calling the loan due when the property changed hands. The sale of property was frequent, given California’s typical short-term turnover of property.

But at the outset of the 70’s, a few larger lenders began to see the judicial handwriting on the wall. They knew they could not rely on the due-on clause as a long-term tool to correct their erroneous financial decisions.

VIR legislation to vary from fixed

Lenders lobbied for legislation to allow them to shift the burden of a changing economy onto owners. The benefit of real estate as a *hedge against inflation* could be shifted from the owner to the lender.

The variable interest rate loan (VIR) was lobbied into legislation in 1969 as a way to pass the cost of inflation to the owners of real estate encumbered by a VIR loan. [CC §1916.5]

Mortgage lenders believed this would help them rectify any misjudgment in forecasting rates for fixed rate loans, while giving them constant earnings of a 2-1/2% to 3% margin on their entire loan portfolio.

Lenders preferred for owners, not themselves, to live with lender miscalculation about future economic uncertainties, and the due-on clause was an excellent conduit for shifting wealth.

Further encumbrance interference

A due-on clause is triggered in several ways:

- on **sale**, the conveyance of ownership;
- on **lease**, a conveyance of the right to possession; and
- on **further encumbrance**, a lien establishing a security interest in property.

A 1971 California lower-court case dealt with an owner who used his equity to secure borrowed funds while still retaining ownership. The owner further encumbered his property with a second trust deed lien to secure the loan.

The first trust deed holder called the loan, claiming the **further encumbrances** breached the due-on clause. The holder claimed the junior trust deed triggered the right to prematurely call the loan due and payable on the unconsented-to further encumbrance of the property.

However, the California Supreme Court held a mortgage lender could not use the due-on clause on the owner's further encumbrance of the property without showing a reasonable justification to protect the loan based on an increased risk of loss brought about by the further encumbrance.

The mere placing of a second trust deed on the property gave the first trust deed lender no legitimate cause for concern over the loss of the loan balance, or the loss of the trust deed position held on title to the property.

In truth, the lender had two individuals with vested interests in keeping the property well maintained and the first trust deed note current. These two were the original trustor/owner and the new second trust deed holder.

The interests of both individuals were junior to the lender's claim against the property's value. Hence, there was no impairment of the lender's security interest in the property due to the further encumbrance. [La Sala, *supra*]

In effect, trust deed liens are intended to **protect the lender** from loss on the loan, not provide him with a sword to cut a better deal or interfere with the owner's exercise of his ownership rights.

As a result, the market for arranging second trust deed loans promptly expanded. Now a private lender could originate a second trust deed loan without the concern the first trust deed holder would call the loan. Loan escrows could once again close on receipt of the existing lender's beneficiary statement.

La Sala permitted owners to obtain additional financing based on the equity of their property. Authority to make second trust deed loans was all most brokers saw in the case. The rule of reasonableness between lenders and owners was mostly overlooked by lenders, agents and owners.

Misdirected attention to security devices

In 1974, the California Supreme Court again looked into lenders' use of the due-on clause. This time a sale of the secured real estate prompted a lender to call a loan due prematurely, claiming the transfer of *equitable ownership* under a land sales contract triggered the due-on clause. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

The *Tucker* court rejected the lender's need for additional profits to enhance their *portfolio yield* as a legal justification to interfere with the change of ownership.

Good faith interference on the part of the lender was now rejected by the court. **Good faith** meant a genuine belief, supported by facts, that the lender's trust deed lien interest in the property was **impaired**, or the transfer to the buyer created a substantial **risk of default** on the loan obligation.

The legal noose was tightening around the economic necks of the lenders.

The need for impairment was so clear that the lender in the *Tucker* case later filed only judicial foreclosures to get legal cover when seeking to use the due-on clause (and intimidate the owner).

Lenders were made aware of the potentially expensive threat of punitive damages for their **tortuous conduct**, due to their lack of good faith in their use of the due-on clause to increase their portfolio yields.

Also, a later case imposed attorney fees on a lender who improperly used the due-on clause against a non-assuming buyer. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

Now the owners of property encumbered by a due-on trust deed had taken on some economic clout. Lenders, for the first time, had something to lose, not gain, when they sought to interfere with the ownership of the secured property for the purpose of increasing their portfolio yield.

Still, some agents used deception when conveying property for clients. More and more contract escrows were opened which held documents off the record until the legal issues regarding due-on clauses were better understood.

Reverse trust deeds became popular. A buyer would be given a note and trust deed from the seller as a lien held by the buyer on the property he purchased, since title remained with the seller.

The phony loan amount would actually be for the amount of the down payment. The seller's grant deed and any carryback trust deed would remain unrecorded. The official record would state the seller was still the owner, and the buyer was merely a lender of funds to the seller — and all this before the passing of Proposition 13 in 1978.

Yet the change of ownership occurred and possession was transferred and the operative documents were held off-record.

Time for the Wellenkamp assumption

The *La Sala* case specifically dealt with further encumbrances in the form of second trust deeds. A footnote in *La Sala* indicated a further review and application would be made of the reasonableness standard when a case involving a sale came along.

Tucker, a case involving a carryback sale, became the fulfillment of the footnote. But the carryback sale was structured as a land sales contract, not a grant deed, trust deed or note.

The facts of *Tucker* regarding the carryback financing device used in the sale distracted nearly everyone from the legal concepts controlling lender conduct on a change in ownership.

The brokerage community focused on the wraparound security device, called a *land sales contract*, used by the seller to document the installment sale of the property.

The form used to document the sale, a land sales contract, and the legal fact the seller merely retained a lien on the property to secure his carryback financing, overshadowed application of the rule which the court applied to lender interference in sales.

Use of a land sales contract caused uncertainty as to whether the same rule would apply to other forms of sale, such as a grant deed conveyance on a cash-to-loan sale.

Thus, the question lingered: Was there justification for calling a loan when the borrower/owner no longer owned any interest whatsoever in the property which secured the lender's real estate loan?

Wellenkamp answered this question without equivocation.

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Chapter 2 — Wellenkamp to Garn

This chapter reviews the legal high ground once held by owners over lenders, and the sudden reversal of owners' rights under federal mortgage law in the early 1980s.

A sale without lender interference

For the decade prior to mid-1974, mortgage lenders consistently threatened to call loans due should the owner sell the secured property and the buyer take title subject to the lender's loan.

No concern existed for the type of property being sold, or arrangements for carryback financing between the seller and buyer. If not paid in full on a call under the due-on clause, or a modification of the interest rate and monthly payments was not agreed to, a Notice of Default (NOD) was recorded. The trustee would then complete the foreclosure unless the loan was renegotiated or paid in full.

By the mid-1970s, most institutional lenders with competent legal advice were aware that courts were not going to allow them to continue using the due-on clause to extort greater yields when owners sold or further encumbered their property. The judicial trend was to return the due-on clause to its former status as a provision designed to **protect the lender** against a loss, not to provide the lender with increased earnings.

Then the case of *Tucker* was decided which required the *good faith* use of a due-on clause by lenders. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

After *Tucker* in 1974, the lenders, virtually en masse, stopped recording NODs on transfers of ownership interests.

However, lenders continued to take advantage of owners and their brokers who were unaware of a property owner's resale rights, or unwilling to undergo the inconvenience of pursuing their ownership rights to sell, further encumber or lease their property when a lender who had a trust deed lien on the property would attempt to interfere.

Lenders continued to play their hand at assumption until sellers, buyers, and brokers learned to call these lenders' bluffs. Brokers and the buying public were slow to catch on, and only did so as the result of individual experiences rather than organizational efforts. A weak real estate sales market eventually spurred buyers and brokers to challenge the lenders.

Agent's conduct with lender of record

Between 1974 and 1978, prior to the *Wellenkamp* decision, agents negotiating sales involving loan takeovers frequently did not understand their clients' rights. Uninformed agents would actually call the lender of record on the listed property to seek advice on a loan assumption by a buyer before writing a purchase agreement offer.

Agents typically asked three questions of the lender with regard to the buyer's assumption of the loan:

- Is the loan assumable?
- What interest rate will be charged on an assumption?

- What points and fees will the buyer be charged to assume the loan?

The lender's response to the agent's inquiry was always adverse to their client's best interests, be he seller or buyer. The lender inferred, due to the nature of the inquiry, that the seller and buyer were ignorant of the buyer's right to take over the loan in a *subject-to sales transaction*.

This environment of agent and buyer ignorance suited the objectives of the lenders perfectly. Lenders could still make good use of the due-on clause against unknowing consumers to increase the yield on their loan portfolio.

Lenders received considerable institutional assistance from brokerage trade groups and federal agencies who supported the lenders' drive to increase earnings, perceiving the survival of institutional lenders as necessary for the financing of the resale of real estate.

But, as the business cycle in 1974 and 1975 brought about tighter money conditions with higher rates, tensions grew. Buyers, sellers and agents asked more questions and became better informed. Information enabled them to cut through to a closing and avoid lender **interference and modification** of loan rates.

On closing a subject-to transaction, the lender was promptly advised of the sale and the buyer's name and address. The transfer arrangements – escrow – had deliberately avoided a note modification and any increased portfolio yield for the lender on their fixed-rate, 30 year loans.

Lenders would press buyers for a formal assumption. When the sellers, buyers and agents presented a concerted front against lender-requested assumptions, lenders eased off from calling loans and filing notices of default.

Thus, by the time *Wellenkamp* was decided in 1978, almost all lenders, including federal savings and loan associations (S&Ls) and private lenders, had dramatically toned down their due-on interference.

Wellenkamp prohibited profiteering

In 1978, the California Supreme Court put a stop to the lenders' use of a due-on clause to vary the term of their loans. The era of automatic use of the due-on clause as a tool to adjust **portfolio yields** was brought to an end.

In California, as in most other states, mortgage law prohibits enforcement of any contract provisions in a trust deed which purports to restrict the owner's right to sell, lease or encumber his property, called a *restraint on alienation*. [Calif. Civil Code §711]

This California law existed even before codes were enacted in 1872. The California Supreme Court decision in *Wellenkamp* simply stated what knowledgeable real estate lawyers already knew — Civil Code §711 made it illegal for lenders to use a due-on clause when their security interests were not placed in **danger of impairment** by a transfer of the secured property to a buyer. [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]

Wellenkamp prohibited any lender interference with a sale, except when it was reasonably **necessary to protect** the lender's security interest in the transferred real estate. Financially, lenders were prohibited from exploiting the due-on clause to increase their **portfolio yield** at the expense of the consumer.

If the seller's prospects of a sale were inhibited by the lender in any way, by the veiled or threatened use of the due-on clause, the lender was now considered to have illegally interfered with the owner's right to sell the secured property.

The lenders who had made mistakes setting interest rates on loans they had originated were now prevented from shifting the cost of those errors onto borrowers.

The California Supreme Court described the provision as the due-on clause, not the due-on-**sale** clause.

The ruling was not limited to just the sales aspect of ownership, any interest was included. In 1982, leasehold assignments were included, barring (until 1990) the landlord's unreasonable termination of the lease on its assignment by the tenant to another tenant.

Lenders were told to use the clause for **protective purposes** only. No longer could the lender use the due-on clause for the economic suppression of the very ownership interest which supported their loans and assured their repayment.

Until 1982, the interest rate risks were to remain with those who created the portfolio yield problem, the lenders.

The Wellenkamp era

After *Wellenkamp*, many agents began advising their clients to consider the use of existing financing to buy property and close transactions in cash-to-loan and carryback sales.

Those brokers who previously had cooperated with lenders who had interfered now advocated *subject-to* financing.

Judicial favor in California was so strongly behind the unrestricted sale of real estate that as late as February 1982, the *Wellenkamp* ruling was finally also applied to private lenders. [**Dawn Investment Co., Inc.** v. **Superior Court of Los Angeles** (1982) 30 C3d 695]

Unfortunately, many lenders placed a high value on their ability to coerce extra profits and simply refused to fully accept the court's decisions.

In particular, the federal savings and loan associations (S&Ls) continued to interfere successfully with sales, arguing that they were not subject to state law.

State lenders also continued to fight but shifted the battle from the legal to the political arena.

In June 1982, the United States Supreme Court gave all federal S&Ls the ability to **automatically** enforce their due-on-sale clauses on a sale, further encumbrance or leasing of the secured property, and do so without concern for the impairment of their security or the buyer's creditworthiness. [**Fidelity Federal Savings & Loan Association** v. **de la Cuesta** (1982) 458 US 141]

This resulted in serious inconsistencies between state and federal due-on practices, seriously hindering the federal S&Ls' ability to lend at rates obtainable by all other institutional lenders.

The recapitalization of lenders by their borrowers

Intended to settle this due-on imbalance and impending wide-spread lender insolvency, the *Garn-St. Germain Federal Depository Institutions Act of 1982 (Garn)* extended to **all** lenders and carryback sellers the rights which *de la Cuesta* gave federally chartered S&Ls.

Together, *de la Cuesta* and *Garn* created a new body of federal mortgage law.

Signed into law on October 15, 1982, *Garn* brought about a blanket preemption of state law limitations on due-on practices.

Garn deemed due-on clauses to be **automatically** enforceable by all lenders secured by real estate or mobilehomes. Thus, previously fixed rate loans with due-on clauses became variable rate loans on the transfer of any interest in the property.

Garn gave both institutional and private lenders the right to enforce the due-on clause which existed as a boilerplate provision in most trust deeds. Thus, since 1982, buyers, sellers, brokers and lenders alike have scrambled to protect their interests and win at the real estate game.

In economic terms, the right to automatic enforcement shifted an enormous amount of wealth from real estate owners to their lenders through loan modifications or new loans at higher interest rates. However, the need for the lender's consent to a sale and the resulting transfer of wealth began to stifle sales.

Garn made one limited concession. A *window period* was established which prohibited due-on interferences by lenders holding loans originated during the window period, except for loans originated by federally chartered savings and loan associations (S&Ls).

In California, this **window period** of loan origination permitted subject-to sales to be closed on properties with loans originated between Aug. 25, 1978 (the date of the *Wellenkamp* decision) and Oct. 15, 1982 (the date *Garn* became law).

The window period allowed owners who bought property during the window period to realize their expectations of reselling the property subject to the old loan. Not so for owners of property encumbered by a federal S&L loan.

Loans which were either originated or assumed during the window period, other than federal S&L loans, were thus **exempt** from automatic due-on enforcement on a resale of the property for **three years** after the window closed. The exemption period was simply a grace period for agents to close subject-to transactions.

The exemption from automatic due-on enforcement applied to the take over of window period loans until Oct. 15, 1985. After that, **any** loan with a due-on clause made or held by **any** lender, institutional or private, could be accelerated on the sale of the secured property without regard to security impairment, risk of default or loan origination date.

The FHLBB steps in

The *Garn* legislation provides only general guidelines for due-on enforcement. The *Garn Act* gave the Federal Home Loan Bank Board (FHLBB), now known as the Office of Thrift Supervision, authority to issue rules, regulations and opinions interpreting *Garn*. This authority was also delegated to other regulatory agencies. [12 United States Code §1701j-3(e)]

In early 1983, the FHLBB issued a set of detailed regulations spelling out what constitutes a sale or transfer, what types of transfers will trigger the due-on-sale clause, and what limitations are placed on the enforcement of the due-on clause.

Transfers which trigger due-on enforcement are those resulting from:

- a grant or quitclaim deed;

- a land sale contract;
- a lease with option-to-buy;
- a purchase under a lease/option;
- a lease for a term more than three years;
- the creation or refinancing of a junior lien (owner-occupied, single family residences excluded);
- the foreclosure of a second trust deed; and
- the transfer into a trust (owner-occupied, single family residences excluded on conditions).

In drawing up these regulations, the FHLBB took care to specifically define what events constitute as a sale or transfer under *Garn*. The FHLBB defines a transfer as the conveyance of any right, title or interest in the secured real estate, whether equitable or legal, voluntary or involuntary (as in a sale of property under a judgment or tax lien sale).

In fact, a completed sale or transfer is not always necessary. With homeowner exceptions, any transfer (sale, encumbrance or lease) will trigger the lender's acceleration rights.

Depending on the wording of the due-on clause in the trust deed, the lender's acceleration right can be triggered by an owner merely entering into a *purchase agreement* to sell the secured property. Options to buy, purchase agreements and sales escrows will trigger the due-on clause if the trust deed so states (though most do not).

Unfinished business

The FHLBB regulations left some significant issues undetermined, and loopholes still exist in the due-on catch-all.

Neither the regulations nor *Garn* itself mention anything about purchase agreements, escrow instructions or limited partnership LLC interests. These loopholes are exploited as paths to avoid due-on enforcement under *Garn*.

Three-year escrow periods with interim occupancy, "agreements-to-agree" and LLCs are only a few of the vehicles the ingenious real estate industry have seen as replacing the subject-to transfer to avoid the shift in wealth which takes place on the sale of property when interest rates on new loans rise.

Chapter 3 Portfolio yields and increasing interest rates

This chapter analyzes the economic impact of due-on interference on real estate transactions, and takes a detailed look at the causes behind the severity of the current real estate downturn and the necessary steps on the path towards recovery.

The failed economic experiment

In 1982, Congress enacted the *Garn St. Germain Federal Depository Institutions Act* (Garn) to provide an **economic catalyst** for rejuvenating the then current cyclical failure of institutional lenders by:

- allowing savings and loan associations (S&Ls) to venture into exotic and highly speculative investments;
- lifting the previous $40,000 federal guarantee on individual savings accounts to $100,000;
- allowing portfolio yields to be increased through loan modifications and recast rights by unfettered use of due-on clauses; and
- eliminating loan rate competition between lenders by awarding them a level playing field.

All these lending conditions – speculation being a naturally pre-existing ingredient – were granted on the premise they would create an environment which would increase S&L earnings. The S&Ls needed to cover their capital losses on fixed-rate loans made in the late 1970s, prior to the "hot money" rules of the newly created money market accounts which dramatically increased their cost of funds.

By the early 1980s, fixed-rate loans and rising short-term rates were blamed for contributing to the extensive insolvency throughout the S&L industry. Thus, the 1970s money market deregulation of S&Ls' cost of funds, followed by the 1982 congressional due-on legislation, brought about mismanagement of the S&Ls which lead to the multi-billion dollar S&L debacle of the late 1980s.

By the mid-1980s, S&L mismanagement, which was allowed to run on too long without regulation or oversight, caused losses the industry could no longer cover by itself. The **Financial Institutions Reform, Recovery, and Enforcement Act** of 1989 (FIRREA) was passed to relieve the S&L industry of its financial insolvency.

The FIRREA was designed to prevent the S&L industry, considered a historically stable source of financing for homeownership, from collapsing. It renamed the S&Ls *thrifts* (which they had proved not to be) and re-regulated the S&L industry to:

- promote a safe and stable system for affordable financing for housing;
- provide better supervision of S&Ls by establishing an oversight agency; and
- limit investments by S&Ls in risky ventures. [12 United States Code §1811]

The financial burden placed on S&Ls by the re-regulation caused most of these institutions to convert themselves into banks to avoid the regulation imposed by the FIRREA.

However, in the reshuffle of legislation, the due-on clause was allowed to remain as a lender's profit-making device, continuing the *Garn* legislative shift of the inflationary hedge in real estate from owners to lenders who held adjustable rate mortgage (ARM) type loans.

The swing in mortgage rates

In California, the due-on clause has not been an issue for buyers and sellers since 1982, the year *Garn* was enacted. After 1982, interest rates generally declined until 1994, then continued to decline from 2000 to 2005. All the while, an abundance of mortgage money was readily available to buyers.

However, whenever inflationary conditions or massive government, corporate, or mortgage borrowing develop in our national economy, short-term and long-term interest rates rise in response.

Gradually, rising short-term interest rates cripple the demands of buyers (who have by then resorted to ARMs to fund their purchase) and temporarily paralyze the related real estate industries of brokers, lenders, credit agencies, title companies, and escrow officers for three years, from peak sales prices to bottom sales prices.

The ability to buy and sell real estate is adversely affected by an on-going general expectation of future increased inflation. *Inflationary expectations* ultimately result in an economic slowdown induced by efforts of the Federal Reserve Bank (the Fed) to increase short-term interest rates to stifle the inflation and the homeowner's use of ARM loans to finance the purchase of a residence.

Ultimately, short-term interest rates must increase faster than the rate of inflation if the Fed is to control the rate of inflation and reduce it to a level acceptable to the long-term bond market. Only then will long-term fixed mortgage rates remain fairly constant or decline, provided that government and corporate borrowing remain static.

Lenders see $ signs in due-on clauses

Lenders are motivated by profit. They do not call loans due or seek a rate modification on a sale of real estate when market interest rates fall below their note rate. Lenders simply permit assumptions of high-rate loans rather than calling them due.

Following the 1982 *Garn* due-on clause enforcement changes, interest rates continued on a downward trend until early 1994. Since 1994, rates have not risen enough or for a long enough period of time to cause brokers to address a practiced technique for handling the due-on issue. As a result, no practical experience with lender due-on interference has been attained by those brokers and agents who became licensed after the elimination of California's free transferability rules in 1982.

However, the early 1990s experienced a nearly eightfold increase in annual foreclosure sales over 1990. The glut of properties in foreclosure further influenced the downward adjustment in home prices which had been initiated by a decline in California employment, a per capita income reduction, and interest rate increases.

The inability of a buyer to take over financing in a subject-to sales transaction without fear of a call inhibited buyers and added to the decline in values. Fewer buyers, including speculators and displaced homeowners, were able or willing to meet institutional demands for loan reductions and assumptions at higher interest rates.

As shown by history, the cycle of values will again turn vicious for owners and lenders when interest rates on new and existing ARMs begin to rise due to the high percentage of loans which are ARMs.

An owner attempting to sell when current rates have risen above the note rate on his existing fixed-rate or ARM loan will experience more difficulty getting a loan assumption approved, except on a modification at current rates, plus the exaction of an assumption fee. These difficulties with lenders will only be exasperated by the fast-growing tendency in the 1990s of agents to step away from further involvement in a transaction once the seller and buyer enter into a purchase agreement.

Thus, lenders are now able to increase their portfolio yield without organized resistance, literally originating a **refinancing by modification** of the terms of the existing trust deed note to meet current lending market expectations.

California agents feel the effects of the due-on clause whenever either variable or fixed mortgage rates increase for a period of time greater than 18 months.

With steady and continuing rate increases, agents will again be shocked by the realization that due-on clauses permit lenders to call a note due (or modify its rate or payment schedule) when an owner seeks permission to sell, lease, or further encumber property financed by the lender.

This severe restraint on all types of real estate transactions was last felt during the 1974-75 recession. However, it was largely avoided by use of all-inclusive trust deeds (AITDs) in the form of land sales contracts with power-of-sale provisions — California documentation of a sale which would not avoid later due-on enforcement by lenders under the 1982 federal mortgage law.

Lenders vs. owners in 2000-2010: the real estate interest of each

In 1998 America's central bank, the Federal Reserve (the Fed) started raising short-term interest rates to induce a routine business recession. As planned, the recession took hold in early 2001. However, the effort to cool the economy was short-lived since the economic reaction to September 11, 2001 froze the price of homes at their peak.

Without real estate going through the normal downward market movement to return prices to their **historical pricing trend**, the stage could not be set for sustainable future real estate prices. Thus, owners of real estate were erroneously led to believe they had come under a new paradigm in economics. This hazardous myth prophesied that the deregulated markets, which had evolved since 1980, would never allow real estate prices to fall below peak levels, but would merely stabilize them for a period until demand would again push prices upward.

After September 11, the Fed and the U.S. Treasury opened the floodgates controlling the flow of money into mortgages. The Fed assisted by lending and buying treasuries in the money markets. In doing so, the Fed added large amounts of fresh cash to the supply of money available through bankers of all sort, be they mortgage or Wall Street bankers.

The cheap, short-term money provided upwards of $2 trillion dollars for lending on ARMs at teaser rates, all with the express government intent to induce tenants into homeownership. This practice was consistent with the government's ultimate goal of driving the percentage of homeownership in the U.S. from the stable 64% figure of the prior 20 years to a destabilizing 70% of the population.

The potential disadvantages of homeownership for those seeking new or transferred jobs due to job loss, an improvement in their labor skills, or coping with family dysfunctions such as divorce or disease, were never part of the dialogue.

Tenants were turned into first-time homeowners. Real estate was purchased without the requisite understanding that as owners they no longer had the mobility to move freely about the country. They became prisoners in their own homes and subject to the local job market since they could not quickly sell them and move.

This flood of money was both in excess of the true needs of people paying for shelter (as either tenants or owners) and cheap for the bankers to borrow (from the Fed and depositors) or receive (by taking profits on bonds driven up in value due to activity of the Fed).

The excess continued until July 2004 when the Fed began to slowly cut off bankers' easy access to the Fed's unlimited pool of funds by continually increasing the interest rate. This action significantly reduced the flow of funds into mortgages.

Providing more than money: deregulation

During the same period, the U.S. Treasury and Congress (encouraged by the Fed) continued deregulating and removing the lending parameters restricting mortgage lenders and Wall Street bankers, a process which had begun in the early 1980s. Deregulation allowed mortgage lenders to take on ever riskier lending activity until 2007, the year mortgage borrowers began defaulting and drowning mortgage lenders with foreclosures caused exclusively by imprudent lending practices.

At the time, the tortured reasoning behind the extensive deregulation of mortgage lenders was that Wall Street would look out for its own best interests. Therefore, excessive risk-taking would not be allowed by mortgage lenders as it would destroy its business of making and bundling loans. This flawed behavioral theory of economics overlooked the force behind *comparative advantage* between competitors of equal footing.

Comparative advantage is a force which drives Wall Street mortgage bankers to produce ever greater profits in a race to retain private sector investors who would otherwise go to the competitor producing a greater profit.

Underlying all this action was the **Reaganomics** doctrine that free enterprise functioned at its best when the risk of less was high enough to compel the bankers to set up appropriate parameters for safe lending in the mortgage markets. Government interference was seen as the problem, not the marketplace entrepreneurs — the logic supporting deregulation of money.

Wall Street bankers became more actively involved in the mortgage business in 2002. They willingly bought thousands of real estate loans at premium prices from mortgage bankers who originated them as rapidly as the Wall Street gang demanded.

Wall Street then bundled these real estate loans into **pools of mortgages**, each pool being separately managed under pool servicing agreements (PSAs), called *servicing*. Participation in the pools was then sold to investors in the bond market to recover the funds advanced by Wall Street to buy the loans, the cost of bundling and selling participation in the pools, and profits.

Each pool held the mortgages they acquired as the assets which backed up the market value of the bonds issued by the pool and provided monthly income to cover the interest due the bondholders. The bondholders eventually consisted of millions of small and large investors, individuals and institutional, domestic and foreign alike.

However, no one bondholder held any one mortgage. Instead, all bondholders in a pool indirectly held a minute interest in all the mortgages held by the pool. This created a chaotic environment, unlike the

Dutch system of mortgage backed bonds which allows homeowners to pay off their loans by buying the mortgage backed bond at toxic asset prices in the bond market. Thus, the homeowner creates his own discount for a short sale or retention of the home.

Mortgage bankers merge into Wall Street

During the rush to buy loans originated by mortgage bankers around the nation, Wall Street began buying up the mortgage bankers to get direct control over profits from both the loan origination and bundling/securitization phases. Thus, they were simultaneously able to

- originate loans at better rates and on more risky terms than a traditional mortgage lender; and
- resell **fractional interests** in those loans via their mortgage pooling to investors in bonds.

Selling mortgage-backed bonds become a world-wide effort as U.S. dollars accumulating in foreign banks needed a "safe" place to go. Bond rating agencies all duly collaborated with Wall Street bankers (for a fee) to assure bond investors all over the world that the mortgages backing their bond acquisitions were as solid as U.S. Treasuries.

Tranches were created within each pool to entitle different classes of investors to different priority claims on the interest income from the mortgages. **Tranches** are similar to first, second, and third trust deed holders who have varying priority claims to the value of the real estate securing their loans.

This Wall Street *modus operandi* was perfected by late 2004 when the Fed belatedly started to slow the flow of funds into the economy by raising interest rates on short-term financing to reduce availabilty. But it was the Fed's short-term financing that had supported the initial Wall Street involvement in mortgages.

However, by the time short-term rates began to rise, Wall Street was almost exclusively relying on private investors in mortgage-backed bonds. Wall Street no longer looked to the Fed to replenish the coffers of the involved mortgage bankers and mortgage loan brokers who were producing the flow of loans Wall Street needed to bundle and sell into the bond market.

The money supply had been increased by the Fed to keep all type of bankers and bond investors flush with cheap cash to invest. After 9/11, the Fed lent at extremely low rates (until their mid-2004 increase in short-term rates) to provide all the funds needed to finance:

- government deficits (too little tax revenue and egregious amounts of expenditures);
- the demands of stock market investors for ever greater leverage in stocks and bonds acquisitions; and
- the real estate market's need for mortgage and equity financing.

The Fed also supplied foreign central banks with dollars so their citizens could get in on the cycle of profits seeming to flow from investment and consumer demands within the U.S. At one 12-month period during the Fed's easy-money phase in the first part of the 2000s, the U.S. dollar supply increased nearly 25%.

The American Dream: policy vs. fundamentals

Considering the real estate investment cycles of boom and bust, the supply of money at cheap rates soon outran the demand buyers of real estate had for cash in the normal course of sales and refinance transactions. The excess mortgage money and equity investment funds were now managed conceptually based on Wall Street stocks-and-bonds analyses. The solid real estate fundamentals which are used to determine the inherent value of each parcel of real estate were not considered.

The uniqueness of each parcel of real estate which supported the mortgage-backed bond pools and made up the assets owned by real estate investment trusts (REITs) has never been understood by Wall Street. For Wall Street mortgage bundlers and first-time investors in real estate, all parcels look the same. Only the yield on the mortgages and profit on a parcel's resale were used to determine real estate values. These parasitic individuals relied on the borrowers and future buyers to produce their profits, largely ignoring the causes of the risks posed by the failure of these parties to "perform."

Going into 2000, the "American Dream" of homeownership was being aggressively pushed onto tenants. The government promotion was so successful it drove homeownership rates among the national population from 64% in 2000 to 70% by 2006.

This race into homeownership was financed by $2 trillion in additional guarantees and borrowings by **Freddie Mac** and **Fannie Mae**, government-sponsored (now government-owned) entities. The funds came primarily from the Fed's massive expansion of the money supply through their money-market operations. It should be remembered that the Fed has an unlimited supply of money, can never become insolvent, and is always repaid.

When money held by investors **starts chasing** real estate deals, be they acquisitions of ownership or mortgage lending, mistakes will be made. The more money and investors involved in the chase for assets, the greater the magnitude of the mistakes. Rational analysis is either set aside to get in on the wild ride for profits, or it is overlooked by newcomers due to ignorance of the rules for judging an investment related to real estate.

Wanting a share of the resurgence of cash into mortgages and real estate equities, real estate brokers and appraisers rationalized their way into the extravaganza of buying, lending, and refinancing by limiting their determinations of value to only comparable sales. However, these sales were being driven artificially by the excessive availability of funds.

Real estate brokers and appraisers deliberately rejected — abandoned — the rational tone carried by historic valuation techniques of *replacement cost approach* (land, labor, and materials) and the *income approach* (present worth of future benefits of ownership).

Even when the **income approach** was implemented, appraisers used a **cap rate** they divined from comparable sales prices. Appraisers deliberately failed to capitalize the net operating income of a project with a rate which included a return of capital, a long-term yield (as though the property were clear of liens), compensation for asset oversight, a reserve for replacement of structural components, and a risk premium for adverse future changes in local demographics.

A call to the wild: scammers, fraudsters and speculators

In addition to the entrance of novice, first-time real estate investors indirectly packaged into real estate via REITS and mortgage-backed bonds, this environment opened the door to scammers, fraudsters, rent skimmers, adverse possessors, and speculators directly owning real estate as hit-and-run types, called *flippers*. These **flippers** sensed a quick profit in an artificial fast-moving rise in sales volume and prices.

Flipping ownership for profit was fertile ground for speculators beginning in mid-2003, and ending abruptly in early 2006, roughly a three-year run. Without the ability to resell within six months to one year, speculators who acquired property had to convert to landlording until market prices recover sufficiently to produce a return on their investment. If no profit could be made, they were forced to walk away with whatever price they could get, or worse: merely pass the keys to the lender under their **put option** in the trust deed.

Real estate scammers engaged in rent skimming by collecting rents from tenants, but deliberately failed to make mortgage payments to the lender. Scammers also appeared under the guise of foreclosure consultants, sometimes cloaked in Department of Real Estate (DRE) advance-fee approvals, or as attorneys (acting as brokers without a brokers' licenses), and short-sale loan discount facilitators.

Real estate fraudsters posed a hazard for title companies as much as they did for lenders. Fraudsters stole the identities or misrepresented themselves as property owners to encumber properties with loans. Unfortunately, most mortgage fraud discovered by institutional lenders occurred through loans originated by mortgage loan brokers. This discovery resulted in institutional lenders avoiding loans packaged by mortgage loan brokers. Loan fraud also occurred when borrowers flipped property between controlled individuals or entities at artificially inflated prices, and, upon the final transfer in the series, applied for what appeared as purchase-assist loans, the type most sought by lenders.

However, on recording the loan and receiving the net proceeds of the financing, they never made a payment, as their profit had been received through the financing. The fraudsters then simply moved on to the next property to flip vestings at what appeared to be increased prices, finance the phony price on the last change in the vesting, and take another profit from the funds received on the refinancing. Fraudsters had quickly figured out a way to profit other than by selling property on a grant deed to a legitimate buyer. Thus, they left the lender (and the appraiser, and sometimes the notary) holding the bag on an excessive loan amount encumbering a low-valued property.

Others just **forged** documents to obtain a loan insured by a title company and left the insurer, not the lender, holding the empty bag – and at great cost to the title insurer as they had to pay out the entire amount of the insured trust deed loan without the ability to resort to any property, even for a partial recovery.

Stable rates and stable pricing

The tide of loan originations was turned back by higher mortgage rates, peaking in volume in August 2005. At the same time, the trajectory for the volume of home sales was beginning to peak, and did so six months later in early 2006. Home prices, the second shoe to drop in home sales during a recession, did not peak until late in 2006.

The mortgage scams and frauds that made the mid-2000s unusually risky existed in previous years, but were fewer in number. It was the chase by Wall Street bankers to originate ever more mortgages to be bundled and sold to remote bond market investors, all of whom had no sufficient grasp of real estate mortgage concepts or ownership default risks to protect themselves from the scammers and fraudsters that dealt in deceit.

All service providers affiliated with the settlement of real estate sales and loan originations, such as escrows, title insurers, mortgage default insurers, real estate brokers, etc., joined the hunt by employing great numbers of employees and agents. These tens of thousands of new employees were brought in during 2003 through 2007, and very few were properly trained to spot fraud, much less to prevent it from occurring.

Moving forward based on cause and effect

The cause of the carnage in the real estate bust following 2006 was the Fed's hyper lending through its open-market operations coupled with the utter failure of regulatory agencies to perform. Congress was a willing accomplice, deregulating mortgage lenders and their Wall Street bankers and removing what few restraints remained on lending after 25 years of loosening controls over mortgage lending.

Without parameters within which lenders had to structure real estate loans, the forces of **comparative advantage** pushed Wall Street bankers to drastic leveraging to keep investors in their programs. This drove them to take on the excessive risk of loss built into ever more exotic loan terms, such as *option ARMs*.

Borrowers taking out ARMs generally had zero ability to pay after the ARM interest rates reset, an effect which gave ARMs the cheerful nicknames back as early as 1982 of **ZAP** (Zero Ability to Pay) and **RIPOFF** (Reverse Interest and Principal for Optional Fast Foreclosure) loans. At the time, all that experienced real estate brokers and investors could do was wait out the cycle.

Veterans of the industry knew the consequence would be a disastrous collapse of both property values and public confidence in real estate ownership and mortgages. They will now have to wait until the bust morphs into a stable (more specifically, flat) volume of sales and prices that remains constant for a period of 12 to 18 months. Then they will be able to acquire real estate below or at replacement cost with a respectable rate of return at a 9-11% capitalization rate more suitable to income property investments – a return to basics once again.

While the Fed mistakenly plowed hugely excessive amounts of funds into mortgage-market situations during the boom and drove prices up, the correct remedy for a recession (or worse) is for the Fed to pump great amounts of cheap money into the banking system for all types of lending in an effort to support prices before they fall too low for lack of funds to finance buyers — deflation.

The future challenge of a well-administered Fed will be to pull back those excessive funds they fed into the banking system during the early part of the recession and do so before prices of consumer goods start to rise more than 2 or 3% annually.

Also, the Fed must change its attitude about asset inflation. In the future, the Fed must act quickly when stock market or real estate prices start to rise. Prices will again rise in both types of investment assets, but at different times — stocks first, followed by real estate two or three years later as in the past. The Fed will need to drive short-term rates up and make the dollar scarcer to keep the lid on asset inflation, something they have only done once before — during the late 1920s.

Mortgage rates will continue to follow 10-year treasury rates at a 1.5% spread after settling down from the spread of 2% which developed after the mortgage bust in 2007. Thus, a 3% 10-year treasury rate will support a 4.5% mortgage rate when the confidence level of the American public rises. Confidence will rise throughout 2009 and 2010 as the public learns more and begins to understand the basic operations of central banks and the U.S. Treasury during times of serious economic recession, typically a one year process.

But the Fed, for the same reasons they bought long-term treasuries in an effort to keep mortgage rates down, can just as easily reverse course as asset inflation begins to take place (property prices move up more than 4-5% per annum) and sell long-term bonds at high rates of interest. The Fed can also push

regulatory agencies and Congress to again regulate the risks a mortgage lender can take (down payment amounts, terms of the loan, type of appraisal – cost, income, and comparable approaches, repayment schedules, variable teaser rates, etc.).

SECTION B

Notes and Their Provisions

Chapter 4 The promissory note

This chapter reviews the types of notes used to evidence debt in financing arrangements which are secured by real estate.

Evidence of the debt

Almost all real estate sales hinge on the financing of some portion of the purchase price. The buyer promises to pay a sum of money, in installments or a single payment at a future time, either to the seller of the real estate or a lender who funds the sales transaction.

Given in exchange for property or a loan of money, the promise to pay evidences a debt owed by the borrower and payable to the seller or lender to whom the promise is made.

Usually, the promise to pay is set out in a written document called a promissory note, signed by the buyer/borrower. A promissory note merely represents an underlying debt owed by one person to another. The signed promissory note is not the debt itself, but evidence the debt exists.

The borrower, called the *debtor* or *payor*, signs the note and delivers it to the lender or carryback seller, also called the *creditor*.

The note can be either unsecured or secured. If the note is secured by real estate, the security device which should always be used is a trust deed. When secured, the debt becomes a voluntary lien on the borrower's real estate or the property purchased, as described in the trust deed.

The promissory note

Notes are categorized by the method for repayment of the debt:

- installment notes; and
- straight notes.

The installment note is used for debt obligations with constant periodic repayments in any amount and frequency negotiated.

Variations of the installment note include:

- interest-included; and
- interest-extra.

Finally, notes are further distinguished based on interest rate calculations:

- fixed interest rate notes, commonly called *fixed rate mortgages* (FRMs); and
- variable interest rate notes, commonly called *adjustable rate mortgages* (ARMs).

Installment note, interest included

An interest-included installment note with constant periodic payments produces a schedule of payments containing diametrically varying amounts of principal and interest from payment to payment. Principal reduction (on the loan) increases and interest paid decreases with each payment. [See Form 420 in Chapter 5]

Each payment is applied first to the interest accrued and owing on the remaining principal balance through the end of the payment period, typically monthly. The remainder of the payment is then applied to reduce the principal balance of the debt.

Interest-included installment notes may either:

- be fully amortized through constant periodic payments until paid; or

- include a final/balloon payment after a period of installment payments, called a due date.

Installment note, interest extra

Interest-extra installment notes call for a constant periodic payment of principal on the debt. In addition to the payment of principal, accrued interest is paid concurrently with the principal installment.

The principal payments typically remain constant, from payment to payment, until the principal amount is fully paid or a due date occurs. Accordingly, the interest payment decreases with each payment of principal since the interest is paid on the remaining balance. [See Form 422 in Chapter 4]

Thus, unlike an interest-included note, the amount of each scheduled payment of principal and interest on an interest-extra note is not constant from payment to payment.

For example, the first payment of interest is based on the entire original unpaid balance of the interest-extra note. The second interest payment will be on the principal amount remaining after the principal reduction resulting from the first payment. To set the amount of each periodic payment, recalculation of the accrued interest paid with each principal payment will continue until the entire note is fully paid.

Straight notes

A straight note calls for the entire amount of its principal to be paid in a single lump sum due at the end of a period of time, perhaps five years after close of escrow or on a fixed future date. No periodic payments of principal are scheduled, as in the installment note. [See Form 423 accompanying this chapter]

Interest usually accrues unpaid and is due with the lump sum principal installment, financing sometimes referred to as a "sleeper" trust deed. Occasionally, the interest accruing is paid periodically during the term of the straight note, such as monthly payments of interest only with the principal all due in seven years.

The straight note is typically used by bankers for short-term loans, called a *signature loan*, since a banker's short-term note is not usually secured by real estate.

NOTE SECURED BY DEED OF TRUST

Straight Note

$_______________, dated _____________, 20______, at ___________________________________, California.

1. ____ after date, for value received,

1.1 I/we promise to pay to ____, as the Payee, or order,

1.2 at ____,

1.3 the sum of ____ DOLLARS,

1.4 with interest from _____________, 20________, on unpaid principal,

1.5 at the rate of ______% per annum.

2. Interest payable:

2.1 ☐ with the principal.

2.2 ☐ on the _______ day of each ___________ month, beginning on the _______ day of ___________, 20______.

3. Principal and interest payable in lawful money of the United States.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

5. ____

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6. In any action to enforce this Note, the prevailing party shall receive attorney fees.

7. This Note is secured by a DEED OF TRUST.

8. ☐ See attached Signature Page Addendum. [**ft** Form 251]

Payor's Name: ______________________________	Payor's Name: ______________________________
Signature: _________________________________	Signature: _________________________________
Payor's Name: ______________________________	Payor's Name: ______________________________
Signature: _________________________________	Signature: _________________________________

Payment variations

While the installment note and the straight note are common, variations on the interest rate and repayment schedules contained in the installment and straight notes are available to meet the specific needs of the lender and borrower. The variations include the:

- adjustable rate note (ARM);
- graduated payment note (GPM);
- all-inclusive note (AITD); and
- shared appreciation mortgage (SAM).

The **adjustable rate note** (ARM), as opposed to a fixed-rate note, calls for periodic adjustments to both the interest rate and the amount of scheduled payments. The interest rate will vary according to a particular index, such as adjustments every six months based on the cost-of-funds index for the 11th District Federal Home Loan Bank.

The ARM provides the lender with periodic increases in his yield on the principal balance during periods of rising and high short-term interest rates.

When an upward interest adjustment occurs, the note's repayment schedule should call for an increase in the monthly payment to maintain the original amortization period. If the amount of the original monthly payment is retained without an increase compared to an increase in the interest rate, a longer or negative amortization results.

Graduated payment (GPM) provisions are in greater demand when interest rates or home prices rise too quickly. Fewer buyers are able to currently meet increased cost of financing home ownership.

A graduated payment schedule allows buyers time to adjust their income and expenses in the future to begin the eventual amortization of the loan. Often a GPM has a variable interest rate, called a *GPARM loan*.

For example, the GPM provision allows low monthly payments on origination. The payments are gradually increased over the first three- to five-year period of the loan, until the payment amortizes the loan over the desired number of remaining years.

However, any accrued monthly interest remaining unpaid each month is added to the principal balance on the carryback note, called *negative amortization*. The negative amortization causes the unpaid interest to bear interest as though it were principal, called *compounding*.

The **all-inclusive trust deed** (AITD) variation is used more often in carryback transactions than money lending. Lease-options, land sales contracts and AITDs become popular in times of recession, increased long-term rates and tight credit.

The lease-option and land sales contract are *security devices* which do not use a note to evidence the debt. Instead, they are themselves evidence of the debt owed the seller on the price. However, the lease-option and the land sales contract contain greater legal risks than the AITD, due to their recharacterization as mortgages, while producing the same financial function and tax result as the AITD.

Figure 1

SHARED APPRECIATION NOTE

Installment — Contingent Interest Extra

$_______________, dated _______________, 20_______, at _________________________________, California.

Items left blank or unchecked are not applicable.

1. In installments, I promise to pay to ____, as the Payee , or order, at ____,

1.1 the sum of ____ DOLLARS,

1.2 with interest from _____________, 20______, on unpaid principal,

1.3 at the rate of ______ % per annum, plus any contingent interest provided for below.

2. Principal and interest payable in installments of $_______________, or more,

2.1 on the _____________ day of each _____________ month beginning on the _____________ day of _____________, 20______,

2.2 and continuing until _____________, 20______, when the principal is due and payable.

3. CONTINGENT INTEREST:

3.1 Contingent interest shall be due on any of the following events:

a. maturity of the note;

b. resale of the property;

c. prepayment of the note; or

d. acceleration of the note.

3.2 Contingent interest shall be payable only from the net appreciated value of the secured property.

3.3 Contingent interest is computed as follows:

a. ______% of the net appreciated value of the property when the contingent interest is due; or

b. ______% annually on the original note amount, compounded annually at the aggregate note rate until the contingent interest is paid.

4. NET APPRECIATED VALUE:

4.1 The net appreciated value is the fair market value of the property when the contingent interest is due, less Payor's original acquisition costs, the value of additional capital improvements made by Payor, and customary resale costs including a brokerage fee.

4.2 Payor's original acquisition cost of the property includes the total purchase price, plus customary escrow and recording fees, title insurance premiums, notary fees, legal fees, credit report fees, appraisal fees, broker fees, loan origination or assumption fees, inspection fees and all other customary costs incurred in acquiring the security.

a. Payor must document the above costs within two months after close of escrow by delivering their escrow closing statement and other supporting documents to Payee.

5. FAIR MARKET VALUE:

The fair market value of the property shall be determined as follows:

5.1 When the security is not being resold, by appraisal on the following method:

a. Payor to obtain and pay the costs of an appraisal of the property value prepared by a certified residential real estate appraiser within three months prior to payment of the contingent interest.

5.2 On resale of the property, the sales price shall be deemed the fair market value, unless Payee contests the sales price in writing within 10 days after receipt of written notification of the sale from Payor. If Payee contests the sales price, fair market value will be the greater of the sales price or the amount determined by appraisal under Section 5.1.

5.3 Payor and Payee may at any time establish the fair market value by mutual agreement.

6. ADDITIONAL CAPITAL IMPROVEMENTS:

Payor may have the value of capital improvements added to his cost of the property by mailing to Payee a cost breakdown for approval prior to undertaking the improvement. If approval is withheld, the value of capital improvements shall be determined by appraisal at the time of improvement under Section 5.1.

— — — — — — — — — — PAGE ONE OF TWO — FORM 430 — — — — — — — — — —

— — — — — — — — — — PAGE TWO OF TWO — FORM 430 — — — — — — — — — —

7. PREPAYMENT: (check one only)

7.1 ☐ For owner-occupied, one-to-four residential units: If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

7.2 ☐ For all other residential and nonresidential property: Privilege is reserved to prepay all or part of this note at any time by paying principal, accrued interest, and six months' unearned interest.

8. LATE PAYMENT:

If any installment payment under this note is not paid within ______ days after its due date, a late charge of $_______________ shall be incurred by Payor and be due and payable upon Payee's demand.

9. BALLOON/FINAL PAYMENT NOTICE:

☐ This note is to contain the following balloon payment notice provision (mandatory on sales of four-or-less residential units): This Note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 days and not more than 150 days before any balloon payment is due.

10. GENERAL PROVISIONS:

10.1 Any unpaid interest shall be added to the principal and thereafter bear interest as the principal.

10.2 Should default occur on any installment of principal or interest when due, then the whole sum of principal and interest shall be due at the option of Payee.

10.3 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

10.4 Principal and interest payable in lawful money of the United States of America.

10.5 This note is secured by a DEED OF TRUST.

Payor: ____________________________________ Payor: ____

Payor: ____________________________________ Payor: ____

FORM 430 04-08

The AITD "wraparound" note typically calls for the buyer to pay the carryback seller constant monthly installments of principal and interest. The carryback seller then pays installments due on the underlying (senior) trust deed note from the payments received on the AITD.

Another variation, the *shared appreciation mortgage* (SAM), is designed to help sellers attract buyers during times of tightening mortgage money, prior to a general decline in real estate sales, when no lack of buyers exists. The SAM is an example of a split-rate note. [See Figure 1]

Under a SAM note, the buyer pays an initial fixed interest rate, called a "floor" or "minimum" rate. The floor rate charged is typically two thirds to three fourths of the prevailing market rate but not less than the **applicable federal rate** (AFR) for reporting imputed interest.

In return, the carryback seller receives part of the property's appreciated value as additional interest, called *contingent interest*, when the property is sold or the carryback SAM is due.

Financial aspects

A note documents the terms for repayment of a loan or the unpaid portion of the sales price carried back after a down payment, including:

- the amount of the debt;
- the interest rate;
- the periodic (monthly) payment schedule; and
- any due date.

The amount of the note carried back on an installment sale is directly influenced by whether the carryback is:

- an AITD note; or
- a regular note.

The face amount of an AITD note carried back by a seller will always be a greater amount than had a regular note been negotiated in any given sales transaction. The AITD note includes the amount of the wrapped loans while a regular note is only for the amount of the seller's equity remaining after deductions of the down payment.

Interest rate limitations on loans

California's usury law limits the interest rate on non-exempt real estate loans to the greater of 10% or the discount rate charged by the Federal Reserve Bank of San Francisco, plus 5%. [Calif. Constitution, Article XV]

A non-exempt loan is usurious if the promissory note provides for an interest rate exceeding the ceiling rate on the day the note is agreed to. Other benefits received by the lender may make a loan usurious when the face amount of the note does not appear usurious. [See Chapter 41]

All real estate loans **made or arranged** by a real estate broker, however, are exempt from the usury restriction. [Calif. Const. Art. XV §1]

Since seller carryback notes are not money loans but rather extensions of credit on a sale, they are not covered by the usury laws. [**Boerner** v. **Colwell Company** (1978) 21 C3d 37]

The trust deed

In most carryback transactions, the buyer gives the seller a trust deed lien on the real estate sold to provide security for payment of the portion of the price left to be paid.

The trust deed attaches the debt to the property as a lien on the property. The trust deed is recorded to give notice (and establish priority) of the seller's security interest in the property. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454]

A trust deed alone, without a monetary obligation for it to attach to the described property, is a worthless trust deed. Although the note and trust deed executed by a buyer in favor of the seller are separate documents, a trust deed can only exist when it secures an existing promise to pay or perform any lawful act. [**Domarad** v. **Fisher & Burke, Inc.** (1969) 270 CA2d 543]

Even though separate documents, the note and trust deed are for the same transaction and are considered one contract to be read together. [Calif. Civil Code §1642]

Satisfaction of the debt

The promissory note, once signed by the borrower and delivered to the lender or its agent, represents the existence of a debt. [Calif. Code of Civil Procedure §1933]

When a secured debt has been fully paid, the trust deed securing the debt must be removed from title to the secured property. [CC §2941]

The trustee under the trust deed will require the original note and a request for reconveyance from the lender before the trustee will release the lender's trust deed lien from the real estate, a process called *reconveyance*.

If the original note has been lost or the note holder cannot be located, the trustee will require a bond be posted in its place before **reconveyance**.

If the lender or the trustee fails to reconvey the security interest after full payment, either may be subject to a civil fine of $300, a criminal fine of $400 and/or six months imprisonment. [CC §§2941, 2941.5]

Chapter 5 Basic provisions in trust deed notes

This chapter analyzes the basic provisions necessarily included in a note for a creditor to enforce collection of the debt evidenced by the note.

Minimum elements for enforceability

The forms for a **promissory note,** more commonly called a *note*, containf the minimum required provisions to describe the amount owed, interest rate and repayment schedule of a debt. The note is *evidence* of a debt created by an underlying agreement to pay money. An agreement to pay money on a future date must be **definite** and **certain** in its terms to be enforceable. [See Form 420 accompanying this chapter]

A note secured by a trust deed typically provides for the payment of installments of principal and interest on a debt amortization schedule.

Occasionally, the terms for payment of a debt set the amount of principal to be paid periodically, with accrued interest paid in addition to the specific principal amount. [See Form 422 accompanying this chapter]

The note is used to document the amount of the debt and terms for its repayment. Note forms also provide a checklist of the minimum fundamental elements of a debt which must be agreed to for it to be enforceable by the creditor or the payor who owns the secured property.

The following analysis and instructions are for the preparation and use of Form 420, an installment note providing for periodic payments of principal and interest. Form 420 is designed for brokers, their agents and escrow officers to document a debt previously created by a purchase agreement, loan agreement or escrow instructions. The note will be prepared concurrent with the preparation of the trust deed used to impose a lien on the real estate for the amount of the debt evidenced by the note. The note will be signed by those who agreed to the debt, called the *payors*, such as the buyers or owners of the real estate which will secure the debt, or, as is most often said, the note.

The numbers on the instructions correspond to the numbers given provisions in Form 420.

Identification of the note

The **dollar amount** of the note is entered at the top left corner of the note and is for identification purposes only.

The actual **principal amount** of the debt to be paid appears in the body of the note at §1.3, or in an *allonge*. The amount of the principal debt may be different from the dollar amount entered to identify the note, due primarily to adjustments and prorations at the close of escrow which may alter the amount initially set as the debt.

The dollar amount entered at the top of the note for identification purposes is also entered in the trust deed to cross reference the note. Thus, the debt becomes secured by the real estate described in the trust deed.

Consider a trust deed securing a debt which makes reference to a promissory note "of same date" to the identification date of the trust deed. In this scenario, the identification dates in the note and its trust deed must correspond to each other.

However, if the trust deed is not prepared on the same date as the identification date for an existing note, the words "same date" should be **stricken** from the trust deed and the date of the note should be entered to identify the note secured by the trust deed, an activity called *interlineation*. [See Form 450 in Chapter 14]

The **location** where the note is prepared is also entered at the top of the note, again for identification purposes only. The location of preparation may differ from the place the payments on the debt are to be made as called for in §1.2.

The entries for the dollar amount, date and city are used when referencing the note.

1. Consideration for the note

The person signing the note, called the *debtor* and entitled the *payor*, must receive something of value in exchange for his promise to pay contained in the note. In the context of real estate finance, the consideration for the promise to pay is the money lent or property sold on credit to a buyer.

The words "for value received' document the buyer's **receipt of consideration** given by the lender (in the form of money) or carryback seller (in the form of property) in exchange for the buyer's promise to pay. A note is unenforceable by its holder unless valid consideration is given to the buyer or borrower in exchange for executing the note. [**Doria** v. **International Union, Allied Industrial Workers of America, AFL-CIO** (1961) 196 CA2d 22; Calif. Commercial Code §3303]

The buyer **promises to pay** the debt owed to the lender or carryback seller according to the terms for repayment *memorialized* in the note, on an installment basis which often includes a lump sum as a final/balloon payment.

An *unconditional promise to pay* is essential for the note to be negotiable — transferable — by the carryback seller.

A promise to pay is considered **unconditional,** unless the promise states:

- an express condition to payment exists;
- the promise is governed by another contract; or
- the rights and obligations concerning the promise are contained in another contract. [Com C §3106]

The note must be negotiable if the seller is to sell or borrow against (*hypothecate*) the note and trust deed. [Com C §3104]

However, the buyer's promise to pay on a note secured by a trust deed is not always enforceable against him personally. On a nonrecourse *purchase-money* loan or a carryback note, secured by the real estate acquired, the promise to pay money is only enforceable by foreclosure on the real estate, and is not enforceable by way of a money judgment against the payors who signed the note. [See Chapter 25]

NOTE SECURED BY DEED OF TRUST

Installment — Interest Included

$_______________, dated _____________, 20______, at ____, California.

1. In installments, for value received, I, jointly and severally, promise to pay to

1.1 ____, as the Payee, or order,

1.2 at ____,

1.3 the sum of ____ DOLLARS,

1.4 with interest from _____________, 20______, on unpaid principal,

1.5 at the rate of ______% per annum.

2. Principal and interest payable in installments of ____________________________________ DOLLARS, or more,

2.1 on the _______________ day of each _______________ month,

2.2 beginning on the _______________ day of _____________, 20______,

2.3 and continuing until _____________, 20______, when the principal is due and payable.

2.4 Principal and interest payable in lawful money of the United States.

2.5 Each payment shall be credited first on interest then due and the remainder on principal.

3. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

4. ____

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5. In any action to enforce this Note, the prevailing party shall receive attorney fees.

6. This Note is secured by a DEED OF TRUST.

Payor's Name: __________________________________

Signature: ______________________________________

Payor's Name: __________________________________

Signature: ______________________________________

Payor's Name: __________________________________

Signature: ______________________________________

Payor's Name: __________________________________

Signature: ______________________________________

1.1 Identification of creditor as payee

The **unconditional promise to pay** must be made to a specific person or persons, whether the person is an individual or an entity, called the *creditor* and entitled the *payee*.

The **name of the lender** or carryback seller as creditor must be entered in the note for it to be enforceable, unless their identity is apparent from the conduct of the parties by the receipt and acceptance of payment. [**Schweitzer** v. **Bank of America N. T. & S. A.** (1941) 42 CA2d 536]

The words "or order" immediately following the name of the creditor (the lender or carryback seller) allow the creditor to *assign* the note. The buyer not only promises to pay the creditor, but the words "or order" extend this promise to whomever the creditor assigns the note and trust deed. [See **first tuesday** Form 445]

The "or order" provision also allows the creditor to designate someone to collect payments and service the note on the creditor's behalf, called *contract collection*. [See **first tuesday** Form 237]

1.2 Place of performance

The note must specify the place where payment is to be made, usually the city or county in which the creditor lives or does business.

If the note is not clear as to the place of performance — delivery of the payments — the location of the creditor is the appropriate place for performance.

The place of performance is important since it determines the proper court for any litigation between the parties, called *venue*, should the note be unsecured and in default, or be a recourse note secured by a trust deed which has been wiped out by the foreclosure of a senior trust deed holder.

If a lawsuit involves the secured real estate, such as a judicial foreclosure, the location of the real estate, called *situs*, determines the county where the action will be filed. [California Code of Civil Procedure §392]

However, if the action only involves a dispute over the terms of the note, not the trust deed, then the place of performance or the location of the carryback seller would be a proper venue. [**Dawson** v. **Goff** (1954) 43 C2d 310]

1.3 The amount of the principal debt

Unless the dollar amount of the **original debt** is entered in the body of the note, the note will be unenforceable due to the uncertainty of the amount due. Also, a note which does not specify the dollar amount of the debt is nonnegotiable. [Com C §3104]

The principal amount of the debt which is entered in the body of the note, like the amount identifying the note, is not necessarily the actual amount of the original debt. Often, the actual principal amount of the debt differs from the dollar amount stated in the note, due to adjustments and prorates in the sales escrow creating the note.

The actual principal amount of the debt on close of escrow is often entered on the back of the note as an endorsement or attached to the note in an *allonge* at the close of escrow.

Generally, escrow is handed a note which has been signed before the note amount is entered, together with instructions to enter the actual principal amount of the debt on closing.

1.4 Interest accrual commencement date

Here, the note specifies the date interest begins to accrue on the principal debt. A rate of interest is not required to make a note enforceable.

Usually, interest begins to accrue on the date escrow closes. However, at the time the note is prepared, the date escrow will actually close is not yet known.

If the exact date interest is to begin to accrue has not been set by prior agreement, the space for the accrual date is left blank when the note is prepared. Escrow is then instructed to fill in the date when closing occurs, or correct the date by *endorsement* or an *allonge* entered or prepared by escrow.

1.5 The interest provision

The note specifies the annual interest rate charged by the lender or carryback seller.

If an interest rate is not called for in the note, interest will accrue at the legal rate (10%) after the due date for payment of the principal. [**Bank of United States** v. **Foreman** (1929) 102 CA 756]

A lender or a carryback seller is not required to charge any rate of interest at all, in which case the rate of interest would be entered as zero. However, the carryback seller must be aware he will report interest income for tax purposes at an *imputed rate*, the applicable federal rate (AFR) for the note, when he charges a rate less than the AFR. When interest is **imputed**, the principal amount of the note is reduced and allocated to interest for the seller's tax reporting purposes only. The buyer and the note are unaffected by the seller's tax issues. [Internal Revenue Code §483; see Chapter 31]

Also, instead of a fixed rate of interest, the parties may agree to a different method of figuring interest, such as an adjustable rate mortgage (ARM) or a shared appreciation at maturity (SAM) note. [See Chapter 11]

2. Installment provision

Here, the dollar amount of each installment of principal and interest is entered on the note.

Only the amount of the constant regular installments are stated in the body of the note. Additional amounts of principal only payments, accrued and unpaid interest, or balloon payments are entered elsewhere on the face of the note.

By the terms of the note, the borrower or buyer promises to pay installments in the amount stated, "or more."

The "or more" clause, unless deleted or restricted by the entry of other provisions, allows the buyer to prepay a portion or all of the debt at any time by making principal payments larger than the amount of periodic installments. Other prepayment provisions added to the note may bar the use of the "or more" clause, or place a dollar penalty on additional principal payments which are paid as allowed by the or more clause. [See Chapter 4]

The lender can charge and enforce a dollar penalty for early payment of principal, within statutory and case law limitations on penalty amounts, if the penalty is provided for in the note. [See Chapter 13]

The lender or carryback seller may negotiate a deletion of the words “or more” to prohibit the buyer from prepaying the note in some situations. Thus, the buyer is **locked into paying only** the agreed-to installments. [See Chapter 14]

2.1 Time of performance

In this section of the note, the day of the month a payment will be due and the period between the payment of installments are entered.

The installment period establishes the frequency of payments and is defined by the number of one or more months separating these payments.

Installment payments are typically due on a monthly basis, payable on the first day of each consecutive month. Thus, the payment period entered on the note is “consecutive” if the installments are due every month. If they are due every other month, the period entered is “second”, or “third” if due quarterly, etc.

A payment becomes delinquent the day after its due date, unless a *grace period* is provided by statute or by agreement in the note. A **grace period** extends the time after the due date for the lender or carryback seller to **actually receive** the payment before it becomes delinquent, *allowing* a late charge to be assessed or foreclosure to be commenced. [See Chapter 12]

2.2 First payment date

The date the payment of installments is to begin is entered on the note in this section. Often, the date of the first payment is 30 days after escrow closes. Alternatively, the commencement of payments could be the first day of the month first following 30 days after the close of escrow, in which case escrow should be instructed to credit the seller with interest which will accrue through the end of the month of closing.

2.3 Date of final payment

Installment payments are to continue until the note is due or paid in full.

Unless prior agreements call for a final/balloon payment, the note should read: “*and continuing until **paid***”, with the word “paid” being entered in the space provided for a date. If a final/balloon payment has been agreed to, enter the date of its payment. Often the due date is set as a fixed period of years after the close of escrow, in which case escrow will be instructed to enter the date of this anniversary when the date is known to escrow—on closing.

2.4 Form of payment

All payments made on a promissory note entered into in the United States, unless agreed to the contrary, are to be made in United States currency, either cash, check, money order or cashier’s check. If an off-shore currency or other medium of exchange (such as a weight of gold) is to be used, the note must provide for it.

2.5 Interest accrual

The note provides for installment payments to be credited first toward interest accrued and then to principal, called an *accrual note*.

NOTE SECURED BY DEED OF TRUST

Installment Note — Interest Extra

$_______________, dated _____________, 20______, at _____________________________________, California.

1. In installments as herein stated, for value received, I/we, jointly and severally, promise to pay to

1.1 ____, as the Payee, or order,

1.2 at ____,

1.3 the sum of ____ DOLLARS,

1.4 with interest from _____________, 20______, on unpaid principal,

1.5 at the rate of ______% per annum.

2. Interest payable on the _____________ day of each _____________ month,

2.1 beginning on the _____________ day of _____________, 20______.

3. Principal payable in installments of ____DOLLARS, or more,

3.1 on the _______________ day of each _______________ month,

3.2 beginning on the _____________ day of _______________, 20______,

3.3 and continuing until _____________, 20______, when the principal is due and payable.

4. Principal and interest payable in lawful money of the United States.

5. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

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7. In any action to enforce this Note the prevailing party shall receive attorney fees.

8. This Note is secured by a DEED OF TRUST.

9. ☐ See attached Signature Page Addendum. [**ft** Form 251]

Payor's Name: _______________________________	Payor's Name: _______________________________
Signature: __________________________________	Signature: __________________________________
Payor's Name: _______________________________	Payor's Name: _______________________________
Signature: __________________________________	Signature: __________________________________

On an **accrual note**, interest is charged only on *unpaid* principal. Interest is calculated and paid periodically after the interest has been earned — accrued. Interest is not prepaid by the terms of an accrual note.

An accrual note differs from an *add-on note*. Interest on an **add-on note** is charged on the original loan amount for the entire term of the loan. The entire amount of interest is then added to the original loan amount to set the total amount of principal and interest to be paid over the life of the note. Computation of interest amounts and principal payoffs on add-on notes are controlled by the Rule of 78.

3. Default provision

The failure of the borrower or buyer to timely pay an installment on the note allows the note holder to declare the note due, called *acceleration*.

The right to accelerate the loan balance is exercised by calling the unpaid principal due. Acceleration does not operate automatically on the occurrence of a triggering event, such as a material default. Thus, the holder of the carryback note must act to call the loan by making a demand on the property owner to pay all sums due. [**Green** v. **Carlstrom** (1963) 212 CA2d 240]

However, a proper call is unenforceable until after a foreclosure has been commenced and the reinstatement period has expired, except in the case of an incurable breach, such as an acceleration under a due-on clause or waste provision. If the debt is secured by a trust deed on real estate, the owner of the real estate has up to five business days before the trustee's sale to cure the default by bringing the loan current and paying no more than the statutorily authorized costs of foreclosure, called *reinstatement* of the loan. [Calif. Civil Code §2924c]

A similar **reinstatement** right exists for notes secured by mobilehomes and automobiles. [CC §2983.3; Calif. Health and Safety Code §18037.5]

However, when the note is secured solely by a security interest in personal property other than a mobilehome or automobile, the lender can accelerate the entire balance due on any default. The terms of the note allowing the personal property lender (except in the instance of mobilehomes and automobiles) to call do not permit a reinstatement of the note and no statutory right to a reinstatement period exists. [Com C §9623]

Further, when the note is **unsecured**, the option to accelerate is not restricted. Any reinstatement permitted must be voluntarily agreed to by the holder of the note. [**Messner** v. **Mallory** (1951) 107 CA2d 377]

4. Additional provisions

Optional provisions for inclusion in the note may be negotiated in purchase agreements, loan agreements, and escrow instructions, such as:

- additional principal payments;
- a prepayment penalty; [See Form 418-2 in Chapter 9]
- late charges and grace periods; [See Form 418-1 in Chapter 11]
- compounding on a default; [See Form 418-1 in Chapter 11]

- a balloon payment notice; [See **first tuesday** Forms 418-3 and 419]
- extension of the due date; [See **first tuesday** Forms 418-3 and 425]
- an option for a payoff discount; [See Form 418-2 in Chapter 9]
- the right of first refusal on the sale of the note; [See **first tuesday** Form 418-4]
- reference to a guarantor; [See **first tuesday** Form 418-5]
- an exculpatory clause; and [See **first tuesday** Form 418-5]
- governing law. [See Chapter 10; See **first tuesday** Form 418-5]

An all-inclusive provision is added to the note when the remaining balance of any encumbrance on the secured real estate is included in the principal of the carryback note and remains the responsibility of the seller to pay, called an all-inclusive trust deed (AITD) note. [See Chapter 22]

5. Attorney fees

The note includes a promise to pay attorney fees if legal action is necessary to enforce or interpret the note.

Although the wording in some attorney fees provisions may appear to be one-sided against the borrower, California law automatically makes the recovery of attorney fees *reciprocal*. Thus, if the borrower is the winning party in litigation on the note and trust deed, he will recover his legal fees from the holder of the note, even though the holder may never have promised to pay attorney fees. [CC §1717]

The attorney fees provision applies not only to the original borrower and lender or carryback seller, but also to their grantees and assignees. For example, a buyer who acquires property subject to an existing loan without entering into a loan assumption agreement is not a party to the loan. However, he can collect legal fees in a successful lawsuit against the lender regarding the note and trust deed since the lender would be able to collect its attorney fees if it prevailed. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

Additionally, the attorney fees provision permits the prevailing party to recover their attorney fees even if the note and trust deed are declared void or unenforceable. [**Manier** v. **Anaheim Business Center Company** (1984) 161 CA3d 503]

6. Identification of security

The note states the debt is secured by a deed of trust.

However, neither the trustee under the trust deed nor the real estate which is the security need to be identified. The link-up is made through the trust deed reference to a note of the same date (or other date entered) with a corresponding amount due to the beneficiary on the note as payee.

7. Borrower identification and signature

At the bottom of the note, the borrower or the buyer, also known as *debtor, payor, obligor* or *trustor*, signs and thus identifies himself as the person promising to pay money to the creditor, whether the creditor is a lender or a carryback seller.

Neither the lender nor the carryback seller signs the note or the companion trust deed.

Chapter 6 Special provisions for a promissory note

This chapter presents provisions which may be added to a promissory note, as supplements to the basic provisions in regular note forms.

Beyond fundamental debt obligations

A *promissory note* contains a buyer's **promise to pay** a private lender or carryback seller the principal amount of the debt agreed to, plus any interest. The note is **evidence** the debt exists.

The schedule and conditions for payment of the principal and interest are also contained in the note.

In contrast, provisions in a *trust deed*, besides referencing the note and describing the real estate liened to secure the debt, primarily address the **maintenance and preservation** of the noteholder's *security interest* in the real estate.

Special provisions added to a note serve to:

- **protect** the noteholder against risk of loss due to late payments, early payoff or other defaults on the note; and
- **comply** with statutorily mandated provisions for controlled transactions.

Special provisions to be considered for inclusion in a **promissory note** include:

- a prepayment penalty [See Figure 1];
- due date extension [See Form 418-3 §2.2 accompanying this chapter; see **first tuesday** Form 425];
- compounding on default [See Figure 2 §2.6];
- balloon payment notice [See Form 418-3];
- grace period and late charges [See Figure 2];
- option for payoff discount [See Figure 3];
- right of first refusal on sale on the note [See Form 418-4 accompanying this chapter];
- reference to a guarantee agreement [See Figure 4 §2.1];
- exculpatory clause [See Figure 4 §2.2]; and
- governing law. [See Figure 4 §2.3]

Prepayment penalties

A prepayment penalty is a charge voluntarily incurred by agreement when a debtor pays off principal on a note before the principal is due by the terms of the note. [See Chapter 9]

A prepayment penalty is enforceable if it is reasonably related to money losses suffered by a private lender or carryback seller, such as the payment of profit taxes incurred by a carryback seller on a premature reduction in principal or final payoff. [**Williams** v. **Fassler** (1980) 110 CA3d 7]

The amount of the prepayment penalty the private lender or carryback seller can charge depends on:

- the **type** of property; and
- the owner's **use** of the property.

A prepayment penalty on a note secured by an owner-occupied, one-to-four unit residential property, when more than 20% of the original amount of the note is prepaid in any 12-month period, is limited to no more than six months' advance interest on any principal prepaid in excess of 20% of the original balance. [See Figure 1 §2.1]

The prepayment penalty on a note secured by an owner-occupied, one-to-four unit residential property may only be charged in the first five years of the note. **After five years**, the note can be prepaid without a penalty. [Calif. Civil Code §2954.9(b)]

Figure 1

*Excerpt from **first tuesday** Form 418-2 —*
Prepayment of Prinicpal Provisions

2.1 *For owner-occupied, one-to-four residential units*:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2.2 *For broker-made/-arranged loans on owner-occupied, single family residences* [Calif. Business and Professions Code §10242.6(a)]:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount in excess of 20% of the remaining principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on the use of any due-on clause.

2.3 *On all other residential and nonresidential property*:

☐ If all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due, on demand, in the amount of ______% of the principal prepaid in excess of the principal included in the regularly scheduled payments, except as prohibited by law on the use of any due-on clause.

FINAL/BALLOON DUE DATE PROVISION

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____________, 20______ at ______________________________, California,

1.2 entered into by ____, as the Payor,

1.3 in favor of ____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as ____

____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For final/balloon payment notes secured by one-to-four unit residential property*:

☐ This note is subject to Calif. Civil Code §2966, which provides that the holder of this note shall give written notice to Trustor, or his successor(s) in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due.

2.2 *For extending the due date for a final/balloon payment*:

☐ The due date will be extended for ______ year(s) if:

a. ☐ all monthly installments due within ______ month(s) of the final/balloon payment due date have been received prior to their delinquency.

b. ☐ ____

____

____

Payor's name: ________________________________	Payor's name: ________________________________
Signature: ____________________________________	Signature: ____________________________________
Payor's name: ________________________________	Payor's name: ________________________________
Signature: ____________________________________	Signature: ____________________________________

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On a loan arranged by a mortgage loan broker and originated by a private lender which is secured by an owner-occupied, single family residence (SFR), up to 20% of the remaining principal balance may be prepaid in any 12-month period without penalty.

The penalty on broker-arranged loans for any prepaid principal exceeding 20% of the remaining balance is limited to six months' advance interest on the excess principal reduction. However, the penalty may be imposed for up to **seven years** after origination of the loan. [Calif. Business and Professions §10242.6; see Figure 1 §2.2]

On notes secured by other than owner-occupied, one-to-four residential units, the noteholder may charge a prepayment penalty limited in amount and time only by reasonableness.

However, if the noteholder intends to collect a prepayment penalty should he ever call the note under a due-on clause in his trust deed (excluding one-to-four unit residential property), the payor must sign or initial a separate prepayment penalty provision which includes a waiver of his right to prepay without a penalty. [CC §2954.10; see Figure 1 §2.3]

Late charges and grace periods

A late charge provision in a trust deed note usually permits collection of an additional one-time fee or interest accrual on the amount of the delinquent payment of principal and interest. [See Chapter 11]

On notes secured by real estate, except a note secured by an owner-occupied single family residence (SFR) or a loan made or arranged by a mortgage loan broker, the **late charge** assessed for the delinquent payment of an installment must be an amount *reasonably related* to:

- the private lender's or carryback seller's actual out-of-pocket losses incurred in preforeclosure collection efforts; or
- the value of the lost use of the delinquent funds. [CC §1671; see Figure 2 §2.3]

Figure 2 *Excerpt from* ***first tuesday*** *Form 418-1 — Late Payment Provisions*

2.1 *For an owner-occupied, single family residence*:

☐ Any installment on this note not received within 10 days after the due date is delinquent and will incur a late charge, on demand, in the sum of 6% of the delinquent principal and interest installment amount.

2.2 *For a broker-made/-arranged loan on any property* [Calif. Business and Professions Code §10242.5(a)]:

☐ Any installment on this note not received within 10 days of the due date is delinquent and will incur a late charge, on demand, in the sum of 10% of the delinquent principal and interest installment amount.

2.3 *On other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If any installment on this note is not received ☐ when due, or ☐ within ______ days of the due date, the installment will be delinquent and will incur a late charge, on demand, in the sum of ☐ $_______________, or ☐ ______% of the delinquent principal and interest installment amount.

2.4 *For a broker-made/-arranged loan on any property, final/balloon payment late charge* [Calif. Business and Professions Code §10242.5(c)]:

☐ If the final/balloon payment due on this note is not received within 10 days after the due date, the final/balloon payment will be delinquent and will incur a late charge on the delinquency and thereafter, on demand, for each month the final/balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.

2.5 *For a balloon payment late charge on other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If the final/balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue at the rate of ______%.

2.6 *For compounding interest on a default on other than one-to-four residential units*:

☐ On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are received.

RIGHT OF FIRST REFUSAL TO BUY NOTE

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____________, 20______, at ______________________________, California,

1.2 entered into by ____, as the Payor,

1.3 in favor of ____, as the Payee, and

1.4 secured by a Trust Deed on real estate referred to as ____ ____.

AGREEMENT:

2. In addition to the terms of the above referenced Note and Trust Deed, Payor agrees to the following:

Right of first refusal to buy:

3. Payee hereby grants Payor a right of first refusal to purchase the Note and Trust Deed.

4. Should Payee decide to sell an interest in the Note and Trust Deed, Payee shall notify Payor of the terms on which Payee is willing to sell and assign the Note and Trust Deed.

4.1 Payor has the option, for a period of _____ days after receiving notice, to purchase the Note and Trust Deed on the terms stated in the notice.

4.2 Should Payor fail to exercise the option within the option period, Payee has the right to sell the Note and Trust Deed to a third party on the same terms stated in the notice to Payor.

4.3 Any sale on different terms reinstates the right of first refusal.

5. If the Note and Trust Deed is not sold and assigned within six months after Payor's receipt of notice, the right of first refusal is reinstated.

6. ____
____
____
____

Payor: I agree to the terms stated above.	**Payee: I agree to the terms stated above.**
Date: _____________, 20______	Date: _____________, 20______
Payor's Name: ______________________________	Payee's Name: ______________________________
Signature: __________________________________	Signature: __________________________________
Payor's Name: ______________________________	Payee's Name: ______________________________
Signature: __________________________________	Signature: __________________________________

A typical late charge provision takes the form of a flat fee or a percentage of the monthly installment or note balance.

However, a late charge provision in a note specifying an increased interest rate on the **entire remaining principal** on default of any monthly installment, called a *default interest rate*, is unenforceable since it is a penalty provision in disguise.

A penalty provision is **void** if it fails to reasonably estimate compensation for the lender's losses caused by the default. The rate of interest on a default can only be applied to the delinquent principal and interest payment since only an installment is delinquent, not the entire principal balance of the note. [**Walker** v. **Countrywide Home Loans, Inc.** (2002) 98 CA4th 1158]

The amount of a late charge on any note secured by an **owner-occupied SFR** is limited to the greater of:

- 6% of the delinquent principal and interest installment; or
- $5. [CC §2954.4; see Figure 2 §2.1]

For loans made or arranged by a real estate broker and secured by **any type of real estate**, a late charge on delinquent monthly payments is limited to the greater of:

- 10% of the delinquent principal and interest payment; or
- $5. [Bus & P C §10242.5(a); see Figure 2 §2.2]

A default on the balloon payment

When a broker-arranged loan contains a due date for a balloon payment, a late charge may be assessed if the balloon payment is not received within ten days after the due date.

The maximum enforceable late charge assessed on the a delinquency of a balloon payment on a **broker-arranged** loan, which can be further assessed for each following month the balloon payment remains unpaid, is an amount equal to the maximum late charge imposed on the **largest installment payment scheduled** in the note. [Bus & P C §10242.5(c); see Figure 2 §2.4]

On all installment sales, except for an owner-occupied SFR, an **increased interest rate** on the remaining principal, triggered by a delinquency of the final/balloon payment, is an acceptable late charge provision. [**Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701; see Figure 2 §2.5]

Figure 3

*Excerpt from **first tuesday** Form 418-2 —*
Prepayment of Prinicipal Provisions

2.4 *Discount for early payoff provision*:

☐ Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the note on payment of the sum equal to the principal remaining unpaid less a ______% discount, plus accrued interest and future advances, for the period expiring _____________, 20______.

Figure 4

*Excerpt from **first tuesday** Form 418-5 —*
Note Enforcement Provisions

2.1 **Guarantee provision**

☐ The Note is guaranteed by ___________________________________, under a Guarantee Agreement dated _____________, 20______, at _______________________________, California. [See **ft** Form 439]

2.2 **Exculpatory provision**

☐ Enforcement of the Note and Trust Deed is subject to the purchase money anti-deficiency provisions of Code of Civil Procedure §580b.

2.3 **Governing law provision**

☐ This Note is governed by California law.

However, as a late charge, any increase in the interest rate triggered by a delinquency is still controlled by reasonableness. [Garrett, *supra*]

For carryback SFR notes and broker-arranged loans, an installment is not late if paid within ten days after the installment is due, called a *statutory grace period*. [CC §2954.4; Bus & P C §10242.5]

Also, on an SFR note or broker-arranged loan, the private lender or carryback seller cannot charge more than one late charge per delinquent monthly installment payment — no matter how long the payment remains delinquent. [CC §2954.4(a); Bus & P C §10242.5(b); see Chapter 12]

Compounding on default

A *compounding-on-default interest provision* is triggered by a delinquency in a payment. Compounding causes interest to accrue on the interest contained in the delinquent installment at the note rate until the delinquent payment and compounded interest are paid. [See Figure 2 §2.6]

Compounding interest provisions are used in lieu of flat fee or percentage late charge provisions.

Under a compounding interest provision, the reinstatement amount includes the delinquent principal and interest payment plus the additional compounded interest which has accrued.

A compounding interest provision is a type of **late charge** since it penalizes the borrower and is triggered by a delinquency in a payment, although no case or statute defines it as such.

As a late charge, the limitations on amounts and grace periods for late charges apply to the enforcement of provisions calling for compounding on default.

Balloon payment notice

A balloon payment is a final lump sum payment of remaining unpaid principal, which is due on an earlier date than had the periodic payment schedule continued until the principal was fully amortized. [See Chapter 12]

A **balloon payment note** secured by an owner-occupied, one-to-four unit residential property is a note which contains provisions for:

- a *final payment* which is more than twice the amount of any of the six regularly scheduled payments preceding the date of the balloon payment; or

- a *call provision*. [CC §§2924i(d), 2957(b), (c)]

A **call provision** gives the private lender or carryback seller the right to demand final payment at any time after a specified period.

All balloon payment notes secured by one-to-four unit residential property must include a reference to the buyer's right to receive a *balloon payment notice* 90 to 150 days before the due date. [CC §§2924i, 2966; see Form 418-3]

Failure to include the balloon payment notice provision in the note does not invalidate the note, but enforcement of the note's balloon payment provision is continued until the 90-day notice requirements are met. [CC §2966(d)]

Extension of due date

A provision may grant the buyer an extension of the due date for a **final/balloon payment** conditioned, for example, on the payment of all scheduled installments without delinquency, or on other consideration, such as a charge or change of terms. [See Form 418-3 §2.2]

An agreement to extend the due date in a carryback note should be considered by a buyer when the term of the note is for a short period of time (less than five years) and the buyer is uncertain about the source and availability of funds for payoff.

Discount for early payoff

A buyer's right to pay off the note early is usually documented in the form of an option to buy the note at a discount. [See Form 418-4]

A carryback seller who prefers to be cashed out before the due date set in his trust deed note could include a discount provision to encourage the buyer to pay off the note within a lesser time period than the due date period. The provision can be structured to give the buyer several months to exercise the option to pay off the debt at a discount on the face value (or remaining balance) of the note.

By exercising the option, the buyer who executed the note may either buy the note and trust deed from the seller by an assignment or request a reconveyance of the trust deed.

Right of first refusal

When the noteholder decides to sell the note, a *right of first refusal* provision contained in the note or a separate agreement allows the owner of the secured real estate to purchase or pay off the note. [See Form 418-4]

If the noteholder decides to sell the trust deed note, the buyer is notified of the amount necessary for payoff.

The **payoff amount** will be the sales price of the note and is set based on the lesser of either:

- the noteholder's listing of the trust deed note for sale, or their offer to sell the note; or
- an offer from an investor to purchase the note, which, if accepted, must be accepted contingent on the buyer's exercise of the right to pay off the note.

The buyer, to exercise the right of first refusal, must then match the price.

However, when granting the right of first refusal, the noteholder must be careful not to set the price in advance by stating a price in the right of first refusal provision.

If the payoff amount is set by a prior agreement, the seller is bound by the amount, even if market conditions allow for a higher value when the seller decides to sell the note.

Guarantor

To protect the private lender or carryback seller from loss due to a default on his trust deed note, the private lender or seller may require a third party with sufficient assets to become *liable on call* for all amounts due

under the note and trust deed, called a *put option*. By guaranteeing the note, a guarantor literally agrees to buy the note from the private lender or carryback seller, a legal process called *subrogation* or *equitable assignment*.

The private lender or carryback seller has three types of third party assurances:

- a co-owner's signature on the note and trust deed;
- a co-signer's signature on the note only; or
- a personal guarantee of the note by one other than the buyer.

When a third party signs the note, the third party becomes **liable for repayment** of the note, subject to anti-deficiency rules protecting co-owners on any type of foreclosures and co- signers on trustee's foreclosures. [California Code of Civil Procedure §580b]

However, if a third party agrees to guarantee the note and trust deed, a **guarantee agreement** is signed by the third party and is **enforceable separately** from the note and trust deed. [See Form 439 in Chapter 39]

If the note is guaranteed, a provision may be included in the note to reference the separate guarantee agreement. [See Figure 4 §2.1]

By referencing the separate guarantee agreement in the note, everyone is on notice of the additional security for the note provided by the guarantee.

Exculpatory clause

An *exculpatory clause* in a note converts a lender's recourse paper into nonrecourse paper. When the note carried back by a seller is either separately or additionally secured by property other than the property sold, the note becomes recourse paper. Thus, the buyer needs to consider negotiating for inclusion of an exculpatory clause as a provision in the note. [See Figure 4 §2.2]

When an exculpatory clause is included in a cross-collateralized note (two or more properties are described in the trust deed as the security), neither the private lender nor the carryback seller can obtain a money judgment for any deficiency on a judicial foreclosure of the secured property. Thus, the note has agreed-to anti-deficiency protection. [See Chapter 46]

Governing law

A private lender or carryback seller involved in negotiating a carryback sale with an out-of-state buyer must include a *choice-of-law* provision to assure judgments arising from disputes on the note will be based on California law. [See Chapter 46; see Figure 4 §2.3]

Chapter 7 — Adjustable rate notes

This chapter considers the use of an adjustable rate note (ARM) by a carryback seller during periods of low short-term interest rates when it is foreseeable those interest rates will rise.

Editor's note — This chapter does not apply to ARMs originated by private lender loans secured by owner-occupied, one-to-four unit residential properties as they, unlike carryback ARM notes, are heavily regulated by state law and federal agencies. [Calif. Civil Code §1916.7]

Bargaining for real estate's inflation hedge

The seller of a parcel of any type of real estate agrees to carry back a note secured by the property. The sale will take place during a phase in the business cycle when real estate related interest rates are rising or are likely to rise in the future.

The seller and his listing agent have indications that both short-term and long-term interest rates are going to maintain (or begin) an upward swing over the next few years of national economic or inflationary upturn.

The **resale value** of a fixed-rate note negotiated before the rise in rates will be decreased by any future rise in interest rates. A future loss of value in the note is an event any seller wants to consider avoiding. The seller wants to be able to sell or pledge the note in the future without having to deal with a loss in its value caused by rising interest rates which were foreseeable.

Can the carryback seller receive both the current interest rate charged for fixed-rate loans and any future increase in interest rates without renegotiating the interest rate on his carryback note every year or two based on due-dates or call options?

Yes! A carryback seller and his prospective buyer can agree to an adjustable rate mortgage (ARM) note. ARM provisions give the carryback seller both the current market rate for fixed-rate loans and a rate adjustment on each future increase in short-term interest rates. Thus, he reduces his risk of a loss in the value of his note due to inflation. [See Form 433 accompanying this chapter]

For the carryback seller to benefit from any future increases in short-term interest rates, the terms negotiated for the note need to include a provision for periodic adjustments of interest, based on:

- a rise in figures in the index selected, such as the twelve month treasury average; and

- an agreed-to margin representing the spread between the current figure in the selected index and the market rate charged by private lenders for fixed-rate loans.

Negotiating a carryback ARM

An agent solicits a seller of income producing property to list the property for sale on terms which include a carryback of short-term junior financing by the seller, called an *installment sale*. The carryback will assist a buyer in financing the price he will pay to purchase the property. The current market rate for a comparable fixed-rate loan made by a second trust deed lender is, say 10%.

ARM Checklist

When negotiating an adjustable rate mortgage (ARM) loan or carryback note, the listing agent, borrower and private lender or carryback seller will need to establish:

- the amount of the note;
- the initial interest rate on the note;
- the frequency of interest rate adjustments;
- the index and margin to be used to adjust the interest rate;
- the life-of-loan floor and ceiling interest rates;
- the amortization period for setting the amount of the periodic principal and interest payments; and
- the due date for the final/balloon payment.

The seller wants to offset the financial risk of what he believes will be a future money market of rising interest rates driven by consumer inflation fears, asset inflation with its excess demand for mortgage funds and corporate financing, and massive government borrowing in lieu of tax revenues.

To hedge against rising rates, the seller wants an adjustable rate of interest on any note he agrees to carry. The initial interest rate sought by the seller for the first six months will be the current market rate for private loans. When the initial interest period runs, the note rate will adjust upward every six months to match any periodic increase in rates as reflected by an index tied to short-term interest rates for treasury bills.

The carryback seller wants his interest rate adjustments to be set by figures from an index based on short-term rates. He believes short-term rates will be driven upward by the Federal Reserve (Fed) more rapidly than long-term rates, and remain up for many months after the decline of long-term rates as the Fed fights inflation.

In addition to an **index figure**, an *interest rate margin* must be set to make the periodic adjustment in the interest rate on the carryback note. The amount of the margin will be added to the index figure to establish the periodic interest rate on the carryback note, called the *note rate*.

When negotiating the amount of the **margin**, consider basing it on the percentage spread between:

- the interest rate currently charged by private lenders on comparable fixed-rate second trust deed loans; and
- the current figure from an index for short-term treasury rates (one-year T-Bills) or lender cost-of-funds (11th District cost-of- funds).

ADJUSTABLE RATE NOTE SECURED BY DEED OF TRUST

NOTE: Not for use by private lenders on owner-occupied, one-to-four unit residential property. [Calif. Civil Code §1916.7]

$_______________, **DATED** _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

1. In installments, I ____, as the Payor,

1.1 promise to pay to____, as the Payee, or order,

1.2 at ____,

1.3 the sum of ____dollars ($_______________) plus interest.

2. Interest to accrue from _____________, 20______ on the unpaid principal at an initial yearly rate of _______ % through the last day of the month of _____________, 20______.

On the first day of the following month and every __________ month thereafter, until paid, interest will be adjusted to the note rate calculated as follows:

2.1 The note rate is the sum of the Index Figure and the Margin, rounded to the nearest one-hundredth of one percent (0.01%).

2.2 The index used to calculate the note rate of interest will be the ☐ 11th Federal Home Loan Bank Board District cost-of-funds, or ☐____.

The Index Figure for the third month prior to the month of the adjustment date will be used to calculate the adjusted interest rate. If the selected index is no longer available, the Note Holder will select a new index which is based on comparable information.

2.3 A margin of ______% will be added to the index figure to determine the note rate of interest.

2.4 The interest rate of this note shall not rise above ______ %.

2.5 The interest rate of this note shall not fall below ______ %.

3. Principal and interest is payable in monthly installments on the first day of each month, beginning _____________, 20______, and continuing until _____________, 20______, when the principal is due and payable.

3.1 The initial installment of principal and interest is to be $_______________.

3.2 Monthly installments payable beginning the next month following each note rate adjustment will be changed to an amount sufficient to pay off the remaining principal at the adjusted note rate over an amortization period of ______ years from the date interest first commenced on this note.

3.3 Borrower may prepay all or part of the outstanding principal amount at any time without penalty.

3.4 Principal and interest payable in lawful money of the United States.

3.5 Each payment to be credited first on interest then due and the remainder on principal.

3.6 In the event this note evidences a money loan and the interest on this note exceeds the limit allowed by usury law and the loan is not exempt from usury laws, excess interest will be applied to the principal.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note Holder.

5. ☐ Special provisions attached.

6. In any action to enforce this agreement, the prevailing party shall receive attorney fees.

7. This note is secured by a trust deed.

Payor: ______________________________	Payor: ______________________________
Signature: ___________________________	Signature: ___________________________
Payor: ______________________________	Payor: ______________________________
Signature: ___________________________	Signature: ___________________________

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Thus, with the amount of the margin set for the life of the carryback note, the carryback seller's yield on the note will change every sixth months as the index figures issued by the government change, reflecting any increase or decrease in short- term interest rates.

In our example, the current market rate for comparable fixed-rate loans originated by private lenders is 10%.

The index agreed to is the one-year constant maturity treasury index, which is at 4%. The margin agreed to is 6%, the difference between the market rate on fixed-rate loans made by private lenders (10%) and the index figure (4%).

Thus, when short-term interest rates increase as the economy or inflation picks up, and the index figure rises as a result, the interest rate on the note will be adjusted accordingly.

Editor's note — In periods when short-term interest rates have peaked or are in decline, as occurred in the early-1980s, in 1989, in 2001, and again in 2007, it is often advantageous for buyers to finance purchases by using an ARM. ARM financing allows their payments to drift downward with declining short-term interest rates. Later, when the note rates on fixed rate loans are at a reduced level, the buyer then refinances the ARM with a fixed-rate loan to provide permanent long-term financing if he intends to continue owning the property.

Conversely, the moment ARM rates move downward to the benefit of buyers, carryback sellers should arrange fixed-rate notes with prepayment penalties to cover losses of future earnings due to an early payoff during a period of reduced rates, part of the normal process during a recession.

Carryback seller

A carryback note provides the seller with a steady stream of relatively management-free future income.

The carryback seller understands an adjustable rate mortgage (ARM) note would help maintain his present *real rate of return* by adjusting his yield to keep up with any increase in inflation. He also knows potential buyers are unlikely to make offers containing terms for a carryback ARM when fixed-rate loans are plentiful and cheap. Also, arranging regular carryback financing, especially an ARM, is foreign to most brokers and agents who began negotiating real estate transactions after the mid 1990s.

What can the seller do to encourage buyers to make an offer containing a provision for a carryback ARM?

The seller and his listing agent should publish information on the seller's willingness to carry back an ARM as detailed in the listing agreement, making the carryback information available to the public and other brokers. Publishing listing information is accomplished primarily through multiple listing services (MLS), electronic networks, flyers and newspapers.

However, if an offer submitted to the seller by a buyer does not include a carryback ARM, the seller can include the carryback ARM in the terms of a counteroffer by preparing and attaching an ARM agreement as an addendum referenced in the counteroffer. [See Form 155-1 accompanying this chapter]

ARMing the AITD

A carryback seller includes an all-inclusive provision in an adjustable rate mortgage (ARM) note to create an all-inclusive ARM.

CARRYBACK ARM ADDENDUM

NOTE: Recommended for use with **first tuesday** Form 150 through 159. Not for use by private party on owner-occupied, one-to-four unit residential property. [California Civil Code §1916.7]

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
☐ Purchase agreement, ☐ Option, ☐ Counteroffer, ☐ Escrow,
1.1 ☐ of the same date, or dated _____________, 20______, at _____________________________, California,
1.2 entered into by ____
1.3 regarding real estate referred to as ____.

TERMS: Buyer to pay the purchase price as follows:

2. ☐ Cash down payment through escrow, including deposits, in the amount of . . . . $_______________
2.1 Other consideration to be paid through escrow . . . . $_______________

3. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . $_______________
payable approximately $_______________ monthly for a period of ______ years, interest on closing not to exceed ______%, ☐ ARM ___________________________.

4. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by __________________ with an unpaid principal balance of . . . . $_______________
payable $_______________ monthly until paid, including interest not exceeding ______%, ☐ ARM, ☐ plus monthly taxes/insurance impound payments.
3.1 At closing, loan balance differences per beneficiary's statement(s) to be adjusted into:
☐ cash, ☐ carryback note, or ☐ sales price.
3.2 The impound account to be transferred ☐ with charge to Buyer, or ☐ without charge to Buyer.

5. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by __________________ with an unpaid principal balance of . . . . $_______________
payable $_______________ monthly, including interest not exceeding ______%,
☐ ARM, due _____________, 20______. ____

6. Assume a bond or assessment lien of record in the amount of . . . . $_______________

7. An ARM Note for the balance of the purchase price in the amount of . . . . $_______________
to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable monthly, or more, amortized over ______ years, beginning on the first day of the month after closing, including interest from closing at the initial yearly rate of ______% for ______ months, and thereafter at the note rate adjusted every ______ months based on a margin of ______% over the 11th District cost-of-funds, or _______________, with a life-of-loan ceiling rate of ______% and a floor rate of ______%, due and payable ____________________________. [See **ft** Form 433]
7.1 This note and trust deed to contain provisions to be provided by Seller for:
☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ _____________________
7.2 ☐ A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]
7.3 ☐ Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]
7.4 ☐ Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302] Seller may terminate the agreement within ______ days of acceptance by delivering to Buyer, Buyer's Broker or Escrow written Notice of Cancellation based on Seller's disapproval of Buyer's credit. [See **ft** Form 183]

8. Total Purchase Price is . . . . $ 0.00

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: _____________, 20______	Date: _____________, 20______
Buyer: ________________________________	Seller: ________________________________
Buyer: ________________________________	Seller: ________________________________

If the existing loan wrapped by an all-inclusive trust deed (AITD) contains a variable interest rate provision, structuring the carryback AITD note as an ARM must be considered imperative. The ARM provision attached to an AITD note protects the dollar amount of the equity attached to the AITD note from shrinking during a rise in short-term rates.

Thus, ARM provisions in the AITD maintain the amount of the payment override (spread) in AITD installments when market rates rise and drive up the interest rate and the amount of the installment payments on the underlying ARM.

As the interest rate on the wrapped loan varies, the AITD's note rate and payment schedule will increase or decrease parallel to the changing interest rate and payments on the wrapped loan. Tying the AITD note rate and payment schedule to variations in the underlying ARM provides the seller with a constant yield and cash flow over the life of the AITD, equal to the override margin set in the AITD ARM note provision.

Converting the ARM note to an all-inclusive ARM only requires adding an all-inclusive provision from a fixed-rate AITD note to the ARM note. The added provision references the inclusion of the balance of the wrapped loan in the principal amount of the AITD note. [See Form 421 §3 in Chapter 34]

The all-inclusive provision is added to the ARM note by entering the provision on the face of the ARM note. If insufficient space exists on the face of the note, attach an addendum to the note which includes the provision and reference the addendum on the face of the note. [See **first tuesday** Form 250]

Chapter 8 — Modification of the note

This chapter discusses the typical modifications of a note, the use of a note modification agreement for negotiations and the modification of note form to implement changes.

Changing provisions in a note

A promissory note is written evidence of a promise made to repay a loan or pay a carryback installment debt. The **provisions in the note** determine a borrower's or buyer's debt payment schedule and interest obligations.

During the life of a promissory note, a lender or carryback seller holding the note and the owner of the secured real estate may agree to change the terms of payment, such as to *modify*, *add* or *rescind* one or more of the note's provisions. Any change in the terms of a note requires:

- *mutual agreement* between the debtor (borrower or buyer) and the creditor (lender or carryback seller holding the note); and
- *consideration* given in exchange for agreeing to the modification, with the exception of bankruptcy. [See Form 426 accompanying this chapter]

Modifications of a note secured by a trust deed usually arise out of a financial necessity experienced by the owner of the secured property. Conversely, profit taxes a seller owes on payoff of his carryback note may cause the seller to be the one to bargain to extend the time for payoff.

The modification of a promissory note is a transaction controlled by rules of contract law. Thus, a written contract, in this example a note, can be modified by:

- a written agreement; or
- an oral agreement. [Calif. Civil Code §1698]

However, for an oral modification to be enforceable, both the lender and the borrower must put the oral modification into effect by taking action on it, called *execution*. To be certain of the modified terms they agreed to, the lender and the borrower must memorialize the modification in a writing.

Negotiations to modify the note are best implemented in writing by filling out a form designed to make an **offer to modify** the note. Importantly, the form functions as a checklist of issues the agent must consider when negotiating a modification. When filled out, the agreement sets forth the terms sought by the person initiating the modification effort. Typically an agent facilitates the negotiations. [See Form 426]

Once the agreement to modify has been negotiated and entered into to set the new terms for payment, a **Modification of the Promissory Note** form is prepared by the agent, broker or escrow officer involved. It is the modification form, not the agreement to modify form, which changes the terms of the **existing debt** from those originally stated in the note. [See Form 425 accompanying this chapter]

AGREEMENT TO MODIFY A PROMISSORY NOTE

DATE:____________________, 20______, at____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. Creditor is the holder of a Note dated ____________________, in the face amount of $_______________, executed by ____, as the Payor, in favor of ____, as the Payee.

1.1 The Note has a remaining principal balance of $_______________, with interest paid through the ______ day of _____________, 20______.

1.2 Unpaid late charges, due and not included in the principal, equal $_______________.

1.3 Advances unpaid, due and not included in principal, equal $_______________.

2. The Note is secured by a trust deed of the same date recorded on ______________________________, as Instrument No. _______________, Records of ____________________________________ County, California, executed by ____, as the Trustor, in which ____ is the Beneficiary.

2.1 The real estate securing the Note under the trust deed lien is referred to as

____.

Assessor's parcel number ______________________________.

2.2 The Note is additionally secured by a trust deed or UCC-1 on other property described as

____.

2.3 Impound account held by Beneficiary for property taxes and insurance has a balance of $_____________.

2.4 The name of the Property Owner of the secured real estate is ____________________________________.

3. The trust deed securing the Note is subordinate to the following senior note and trust deed

3.1 recorded on __________________, as Instrument No. _____________,
records of ____County, California,
executed by ____, as the Trustor,
in which____ is the Beneficiary,
securing a note in the face amount of $_______________, with an unpaid balance of $_______________,
principal and interest payable $_______________ monthly, including _____% interest, ☐ ARM,
type _____________, ☐ plus impounds, all due and payable _____________, 20______.

3.2 ☐ See attached addendum for further senior encumbrances.

4. The trust deed securing the Note has priority over the following junior note and trust deed

4.1 recorded on __________________, as Instrument No. _____________,
records of ____County, California,
executed by ____, as the Trustor,
in which ____is the Beneficiary,
securing a note in the face amount of $_______________, with an unpaid balance of $_______________,
principal and interest payable $_______________ monthly, including ______% interest, ☐ ARM,
type _____________, all due and payable _____________, 20______.

4.2 ☐ See attached addendum for further junior liens.

TERMS:

5. The Note is to be modified as follows:

5.1 Interest on the unpaid principal to be at the annual rate of ______%, commencing ___________, 20______.

5.2 Monthly payments shall be $______________, commencing with the month of ____________, 20______.

5.3 The remaining principal balance to be due and payable _____________, 20______.

5.4 ☐ **Impounds:** The Property Owner, with the payment of each Note installment, to deposit with Creditor one-twelfth (1⁄12) of the annual requirement for the payment of taxes and fire insurance. An advance deposit for such payment to be made to Creditor on modification in the amount of $_______________.

6. ☐ See attached addendum for additional modifications of the Note and trust deed. [See **ft** Form 250]

7. Property Owner to deliver additional consideration to Creditor in the form of:

7.1 ☐ The Buyer of the secured property is to assume the Note. [See **ft** Form 431]

7.2 Out-of-pocket costs incurred by Creditor in the amount of $______________.

7.3 Bonus or points in the amount of $______________.

7.4 Payment toward reduction of the principal balance in the amount of $______________.

7.5 ☐ Additional, or ☐ Substitute, security for the Note in the form of a trust deed on property described as
____
____,
which will be junior to an existing trust deed securing a Note with an unpaid balance of $______________, payable $______________ monthly, or more, including interest of ______%, all due ______________, 20______.

7.6 ☐ Property Owner to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

7.7 ☐ See attached addendum for additional consideration. [See **ft** Form 250]

AND IT IS FURTHER AGREED:

8. This offer will be deemed revoked unless accepted in writing within ______ days after date and acceptance is personally delivered to Offeror or Offeror's Agent within the period.

9. This transaction to be escrowed with ____. Signed instructions to be delivered to escrow as soon as reasonably possible after acceptance.

10. Escrow to be handed all instruments needed to close escrow ☐ on or before ____________, 20______, or ☐ within ______ days after acceptance. Property Owner to pay all escrow and title company charges.

11. The Note and trust deed are to be insured by ____________________________ Title Insurance Company under:

11.1 A ☐ CLTA form policy, or ☐ ALTA form policy, of title insurance; or

11.2 ☐ An endorsement of the existing policy, held by Creditor; and

11.3 Showing title subject to property taxes, CC&Rs, and underlying trust deeds in §3;

11.4 With a specific subordination agreement to be obtained from all junior encumbrances listed in §4; and

11.5 Paid for by Property Owner.

12. ☐ Property Owner to obtain beneficiary statement(s) on underlying encumbrance(s) showing all payments to be current and confirming their terms and unpaid balance(s).

13. Creditor to incur no costs or charges under this agreement or the modification of the Note.

14. Brokerage Fee:

Property Owner on closing to pay Broker ________________________________ a fee of $______________.

Broker's Name: ______________________________ Broker's DRE Identification #: ____________________

Agent's Name: ______________________________ Agent's DRE Identification #: ____________________

Signature: ____

Address: ____

Phone: ____________________________________ Fax: ____________________________________

Email: ____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: ____________, 20______	Date: ____________, 20______
Creditor's Name: ______________________	Property Owner's Name: ______________________
Creditor's Name: ______________________	Property Owner's Name: ______________________
Signature: ______________________	Signature: ______________________
Signature: ______________________	Signature: ______________________

Provisions in the modification form identify the promissory note which it modifies, names the parties to the note and identifies the trust deed and the property involved in the transaction.

To complete the paper work called for in the agreement, the prepared and signed modification form is attached to the promissory note as an *allonge*, the terms of which then become part of the original note.

On a modification, the note itself should not be canceled or rewritten, especially if it is secured by a trust deed. The dates of the note and trust deed will differ if the note is redrafted, even though the debt evidenced by the new note remains the same with only a change in the terms for repayment of that debt. The different dates will cause difficulty on foreclosure or reconveyance of the trust deed since the recorded trust deed refers to the secured debt as that evidenced by a note "of same date" as the identification date on the trust deed.

Common modifications of a trust deed note include:

- a due date extension;
- interest rate changes;
- installment payments rescheduled or changed in amount, either temporarily or permanently;
- cash advances or accrued interest added to principal; and
- the addition of special provisions.

Owners of real estate encumbered by a debt secured by a trust deed lien, and lenders or carryback sellers as creditors holding that lien, agree to the modification of the note which evidences the debt for many reasons:

Scenario 1

A buyer of real estate is willing to cash out a seller's equity in real estate and **assume the existing** recourse loan which encumbers the property, called a *cash-to-loan* (CTL) transaction.

However, the seller is unwilling to remain liable for the recourse loan, even though the buyer agrees to assume the loan. Due to the listing agent's negotiations, the lender, buyer and seller agree to the buyer's **assumption** of the loan together with the lender's **release** of the seller from further liability on the loan, a combination of activities called a *novation*.

The novation agreement is accompanied by an agreement to modify the note held by the lender, the modification being the *consideration* received by the lender for its release of the seller's liability for the debt. The modification agreement calls for:

- an increase in the note's interest rate and monthly payments; and
- payment of an assumption fee to the lender.

MODIFICATION OF THE PROMISSORY NOTE

DATE: ____________________, 20_____, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This is a modification of a promissory note
  1.1 executed by ____, as the Payee,
  1.2 in which ____, is the Payor,
  1.3 dated __________________, at ____, California,
  1.4 in the original amount of $______________.

2. The promissory note is secured by a deed of trust of the same date
  2.1 executed by ____, as the Trustor,
  2.2 in which ____ is the Beneficiary,
  2.3 recorded on __________________________, as Instrument No. ______________________________,
  in the records of ____ County, California,

3. regarding real estate referred to as ____
____.

AGREEMENT:

4. The above mentioned promissory note is modified as follows: ______________________________________
____
____
____
____
____
____
____
____
____
____
____
____
____
____
____

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: ____________, 20_____	Date: ____________, 20_____
Payee's Name: ______________________________	Payor's Name: ______________________________
Signature: ______________________________	Signature: ______________________________
Signature: ______________________________	Signature: ______________________________

Scenario 2

An owner of real estate has property which is located on an earthquake fault line or in the path of the prevailing wind from a nuclear power plant. The existing trust deed loan encumbering the property is recourse paper.

The owner is concerned about his future liability exposure should an earthquake or nuclear disaster render the property valueless. If disaster **reduces the property's value** below the amount owed on the loan, the owner would be personally liable for the deficiency should the lender need to foreclose, and do so judicially, a risk of loss he wishes to eliminate.

The trust deed on the property calls for the owner to carry **earthquake insurance** which would shift the risk of loss from the owner to the insurance carrier. However, the premium for the insurance policy has become too expensive.

The owner seeks a loan modification with the lender, increasing the interest rate in exchange for:

- elimination of the earthquake insurance provision; and
- a release of the owner's liability should the security become impaired due to causes beyond his control, called an *exculpatory clause*. [See Chapter 6]

Scenario 3

A seller carries back a note and first trust deed on the sale of an unimproved parcel of real estate. Later, the buyer asks the seller to subordinate his carryback trust deed to a construction loan, an event which would increase the seller's risk of loss and automatically convert the carryback note to recourse paper.

The carryback seller will **subordinate** the carryback trust deed to a construction loan if the buyer modifies the note to increase the interest rate and monthly payments, and record a **Request for Notice of Delinquency** (NODq) and serve a copy on the senior lienholder. [See Form 412 in Chapter 48]

*Editor's note — The modification of the interest rate on a carryback note is not subject to usury laws, whether or not the modification is negotiated by a real estate broker. [**DCM Partners** v. **Smith** (1991) 228 CA3d 729]*

*If a modification or replacement note restructures the debt created by a carry back credit sale and the debt remains secured solely by the property sold, the debt remains outside the interest rate limitation imposed by the usury laws. The debt retains its original purchase-money anti-deficiency characteristics since the modified or replacement note evidences a **continuation** or* **rollover** *of the original carryback debt. [**Ghirardo** v. **Antonioli** (1994) 8 C4th 791; see Chapter 43]*

Scenario 4

A dispute arises between a buyer and carryback seller after the close of escrow about the **seller's representations** concerning the property's condition.

The carryback seller offers to modify the note by reducing the note balance and the monthly payments to compensate the buyer for an over-valuation of the property in exchange for the buyer releasing the seller from any further claims concerning the condition of the property and the purchase transaction.

The buyer agrees to modify the note and enter into a release and waive of any future claims as offered by the seller.

Scenario 5

An owner of real estate executes a trust deed note with a five-year due date. Later, with the due date of the final/balloon payment approaching, the owner realizes he will be unable to meet a demand for the final payoff of the note.

The owner contacts the noteholder to negotiate a **due date extension** for the payoff of the note.

The noteholder offers to extend the payoff date if the owner agrees to:

- a higher interest rate and increased monthly payments; and
- allow the noteholder to run a credit check for any change in the owner's financial status since originally entering into the note. [See Form 302 in Chapter 31]

Scenario 6

A seller carried back a note containing a five-year due date. By its terms, the note will soon be due.

However, the seller does not want the note paid off at this time since **capital gains taxes** will be due on the profit in the final/balloon payment. Payment of the taxes will reduce his net worth and income. Also, the current market interest rate is much lower than the interest rate on the carryback note.

The seller wants to negotiate an extension of the due date and include a prepayment penalty in the note, sufficient to cover his profit taxes if prepaid. The seller will lower the interest rate — possibly below market rates — in exchange for the buyer agreeing to an extension of the due date and a prepayment penalty.

Junior lienholder is subordinated

Most debts relating to real estate are secured by a **lien on title** to the real estate, typically a recorded trust deed which describes the property involved and is insured by a title company.

Since the priority of the trust deed is insured, an agreement to modify the trust deed note should always be conditioned on re-insuring the trust deed by obtaining a title insurance policy or an endorsement to the existing policy held by the lender or carryback seller.

Title insurance is needed to assure a lender or carryback seller of the **continued priority** of his trust deed as against the interest of others on title to the real estate.

For example, consider a property which is encumbered by first, second and third trust deed liens. The terms for payment of the second trust deed note are modified.

However, the modification of the interest rate, payments or due date, or a combination of these, cannot result in a substantial economic change in the terms of the debt which would put the third trust deed holder at a significantly greater risk of loss than already exists. If it does, the trust deed securing the modified note will lose its priority on title. To avoid loss of priority on a significant modification, the third trust deed holder must agree to being subjected to the greater risk of loss, called *subordination*.

Consider a holder of a first trust deed lien on a parcel of real estate who agrees to modify the trust deed note. The modification agreement entered into shortens the note's due date, raises the interest rate and increases the amount of principal due.

The holder of a second trust deed claims the first trust deed lien lost its *priority* to his trust deed since the modification of the first trust deed note significantly reduced the value of the second trust deed holder's security interest in the property.

The first trust deed holder claims only the modifications in the note lose priority to the second trust deed since only the modified portions of the note would impair the secured position of the second trust deed.

Here, the agreement which modified the original note does not have priority to the second trust deed, but the terms of the original note do retain their priority. Thus, the second trust deed lien remains unimpaired by the modification in the first trust deed note and in the same financial and legal position as when the second trust deed was recorded. [**Lennar Northeast Partners** v. **Buice** (1996) 49 CA4th 1576]

Now consider a seller who carries back a second trust deed on the sale of property which is subject to a first trust deed containing a due-on clause. The holder of the first trust deed note is not advised of the sale.

Later, the first trust deed lender learns of the sale and calls the loan. To avoid the call, the buyer assumes the first trust deed loan and modifies the note to shorten its due date.

On discovering the modifications, the carryback seller claims his second trust deed now has priority over the first trust deed since the modification on the note secured by the first trust deed substantially impairs his security by increasing the potential for default.

In this example, the modification of the note secured by a first trust deed without the consent of the junior carryback seller does not result in a change in trust deed priorities. The secured property was sold (and the seller accepted a second trust deed) without first obtaining the lender's prior written consent. Thus, the seller breached the due-on clause in the lender's trust deed. Due to the breach, no duty is imposed on the first trust deed lender to avoid impairment of the owner's second trust deed lien. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

However, the modification of an existing trust deed note does not trigger the due-on clause in trust deeds of record on title to a property. Only the initial act of *creating* a security interest, such as occurs by re-cording a trust deed, not the later modifying of the secured note, triggers the due-on clause.

Title insurance

A policy of title insurance on the modification of a trust deed note is obtained to assure the trust deed holder that any junior trust deed liens of record will be considered junior after the note modification. An owner seeking the modification of the trust deed note usually pays the premium charged for the title insurance policy.

The junior trust deed holder, even if he has agreed to a *future subordination agreement* permitting the owner to later modify the senior trust deed note, will be required by the title insurance company to sign a *specific subordination agreement* on title company forms before the trust deed securing the modified note will be re-insured.

Chapter 9 Prepayment penalties

This chapter discusses the financial consequences experienced by an owner of real estate on the prepayment of a debt secured by the property when the note evidencing the debt includes prepayment provisions.

Debt reduction as a costly privilege

An owner of real estate who wants to reduce or pays off principal on a debt evidenced by trust deed note **before** it is due by its terms may have previously agreed to an extra or additional charge the lender can levy to reduce or pay off the debt, called a *prepayment penalty*. The penalty agreement is included in the promissory note, not a provision in the trust deed, since it relates to the payment of the debt, not the care and maintenance of the real estate.

The unscheduled prepayment of any principal on a debt before it is due by the terms of the note is considered a **privilege**. If a prepayment penalty provision is agreed to, a lender can exact a bonus on each exercise of the privilege, whether the reduction is a portion or all of the principal remaining on the debt. [See Form 418-2 accompanying this chapter]

Historically, prepayment penalties were used by lenders in an effort to prevent the loss of interest during the period following the receipt of principal until the funds were re-lent to another borrower.

California courts have embraced a number of rationales which support lender enforcement of the prepayment penalty, including:

- **Administrative costs**: The net costs and the loss of profit (earning) incurred by a lender on the unscheduled reduction of principal [**Hellbaum** v. **Lytton Savings and Loan Association** (1969) 274 CA2d 456];

- **Lag time**: The loss of interest income due to money sitting idle between payoff and re-lending [**Lazzareschi Investment Company** v. **San Francisco Federal Savings and Loan Association** (1971) 22 CA3d 303];

- **Lender profitability**: Use of the prepayment penalty as a device to enable lenders to maintain a generous loan portfolio yield [Lazzareschi Investment Company, *supra*];

- **Lender expectations**: When a lender is committed to a long-term return of funds, prepayment disrupts its expectations [Lazzareschi Investment Company, *supra*]; and

- **Loss due to falling market rates**: Income lost due to prepaid funds being re-lent at lower interest rates than originally bargained. [**Sacramento Savings and Loan Association** v. **Superior Court** (1982) 137 CA3d 142]

Economic reality

For each justification in support of the need to receive prepayment penalties offered by lenders, a counter-argument exists:

- **Administrative costs**: Costs incurred by lenders when re-lending the funds by making new loans are always recovered up-front. Items, such as loan origination fees and charges received by a lender to re-lend the funds from a payoff, always offset lender costs incurred to re-lend principal to fund new loans;

- **Lag time**: Cash on hand does not sit idle in today's lending institutions. Lenders used to have a saying, "Lettuce rots if it sits on the shelf." Unlike lettuce, prepaid funds are promptly re-invested in short-term securities until placed again in long-term mortgages; and

- **Lender profitability**: When lenders call loans on the transfer of the secured property, they do so only because they can re-lend the money at higher rates. They welcome the prepayment of fixed-rate loans in markets of rising interest rates since principal repaid and re-lent increases their portfolio yield and helps maintain profitability, the prepayment penalty earnings being a bonus.

While it can be argued lenders should have the right to collect prepayment penalties to compensate for losses incurred when re-lending funds in a declining interest market, this argument is inapplicable when interest rates are rising.

However, prepayment penalty provisions are enforced on premature principal payments in both rising and falling interest rate markets;

- **Lender expectations**: The *Hellbaum* and *Lazzareschi Investment Company* decisions stress the belief that having made long-term commitments, lenders can expect long-term benefits.

When viewed against lenders' adjustable rate lending practices and many of the portfolio yield claims made with regard to the due-on controversy, this argument fails to withstand analysis.

Lenders expect loans to be paid prior to maturity. Lenders take the risk of prepayment into consideration when setting interest rates or evaluating the worth of a portfolio of loans. The standard industry long-term projection shows the average mortgage prepays by its twelfth year. In California, the average in the 1990s was a mere five years due to several refinancing episodes as rates constantly declined, and again in the mid-2000s as home values doubled or tripled and refinancing conditions converted real estate equities into ATMs.

Such turnover generates profits from loan origination fees, points and interest rate adjustments. It is reasonable to assume prudent lenders base their annual profit projections on portfolio turnover.

Further, with the predominant secondary mortgage market, many institutional lenders pool and sell their mortgages on an advantageous change in interest rates, and generally do not own the mortgages with the intent of obtaining long-term income.

To justify prepayment penalties by citing lenders' expectations of long-term returns seems unjustified when viewed against adjustable rate loan (ARM) lending and loan turnover history; and

PREPAYMENT OF PRINCIPAL PROVISIONS

Penalties and Discounts

DATE _____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____________, 20______ at ______________________________, California,

1.2 entered into by____, as the Payor,

1.3 in favor of ____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as ____

____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For owner-occupied, one-to-four residential units*:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2.2 *For broker-made/-arranged loans on owner-occupied, single family residences* [Calif. Business and Professions Code §10242.6(a)]:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount in excess of 20% of the remaining principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on the use of any due-on clause.

2.3 *On all other residential and nonresidential property*:

☐ If all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due, on demand, in the amount of ______% of the principal prepaid in excess of the principal included in the regularly scheduled payments, except as prohibited by law on the use of any due-on clause.

2.4 *Discount for early payoff provision*:

☐ Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the note on payment of the sum equal to the principal remaining unpaid less a ______% discount, plus accrued interest and future advances, for the period expiring _____________, 20______.

Payor's name ________________________________	Payor's name ________________________________
Signature___________________________________	Signature___________________________________
Payor's name ________________________________	Payor's name ________________________________
Signature___________________________________	Signature___________________________________

- **Loss due to declining market rates**: For the declining market argument to succeed, penalties would be appropriate only when market rates drop below that of the prepaid loan, and only when the various front-end charges and points accruing over the life of the loan as well as the lender's cost of funds at the time of the prepayment are also taken into consideration.

Thus, it seems that all but the rarest situations, such as a catastrophic fall in long-term interest rates without a corresponding and immediate fall in short-term rates, prevent lenders from experiencing losses simply because of an early payoff.

Enforceable penalties

A property owner's right to prepay principal to reduce his debt or payoff and release the trust deed lien on his property is established by:

- the terms of the note;
- legislation and regulation; and
- case law.

A contractual bar against voluntary prepayment, called a *loan lock-in clause*, is **enforceable** if the borrower is aware of and agrees to the terms of the loan lock-in clause, unless:

- the note is secured by one-to-four unit residential property [Calif. Civil Code §2954.9(a)];
- the note is a variable interest rate secured by one-to-four residential units, and within 90 days of notification of a change in the rate, the borrower prepays the note [CC §1916.5(a)(5)];
- the debt is evidenced by a land sales contract which provides for the land to be subdivided into lots of one-to-four residential units and prepayment is postponed not more than 12 months [CC §2985.6(a)]; or
- the property subject to a trust deed is acquired for public use. [Calif. Code of Civil Procedure §1265.240]

Also, a seller carrying back a note secured by a trust deed on one-to-four unit residential property can **bar prepayment** in the calendar year of the sale, unless the seller has already carried back notes on more than four sales within the same year. [CC §2954.9(a)(3)]

Further, the amount a lender or carryback seller can charge on prepayment of the debt depends on:

- the type of property;
- the owner's use of the property; and
- the broker's involvement in negotiations.

Owner-occupied residential property

A prepayment penalty in a note, secured by an **owner-occupied, one-to-four unit residential property** can only be exacted during the first five years after closing, unless a broker is involved arranging the note. [CC §2954.9(b)]

When a loan is made or arranged by a real estate broker and secured by an **owner-occupied, single-family residence (SFR)**, a prepayment penalty may be agreed to an enforced during the seven years immediately following the recording of the trust deed. [Calif. Business and Professions Code §10242.6]

Collection of a penalty in both situations is limited to the amount of principal prepaid during any one calendar year which exceeds 20% of the original loan amount. Also in both cases, penalties cannot exceed an amount equal to six months interest on the amount prepaid which exceeds 20% of the original amount of the note. [Bus & P C §10242.6(a); CC §2954.9(b)]

Consider a buyer who enters into a purchase agreement to acquire vacant property on which he will build his home.

The seller carries back a note and trust deed on the property. The note contains a 33% prepayment penalty, an amount sufficient to cover the state and federal income tax due on the profit in the note on the seller's receipt of a payoff.

Later, the buyer pre-pays the note and the entire 33% prepayment penalty demanded by the seller. The buyer now seeks to recover the penalty he paid, claiming the prepayment penalty provision was unenforceable since the amount of the penalty exceeded the limits allowed on the prepayment of a note secured by an owner-occupied, one-to-four unit residential property.

The seller claims the limitation does not apply to the prepayment penalty since, at the time of purchase, the property was an undeveloped parcel of land.

Can the seller enforce the 33% prepayment penalty?

No! The carryback seller expected the property to become an owner-occupied residential property during the life of the debt by agreement. Thus, the *statutory limitation* on the amount of the prepayment penalty applied to the buyer's note, rendering the penalty unenforceable. [**Garver** v. **Brace** (1996) 47 CA4th 995]

Due-on clause and prepayment penalties

Other approaches are available to buyers and sellers of one-to-four unit residential property who want to avoid a prepayment penalty on the payoff of a debt.

Prepayment penalty provisions in all notes secured by a trust deed which contains a **due-on clause** and encumbers an owner-occupied, one-to-four unit residential property are unenforceable if the lender or carryback seller:

- calls the loan due for a transfer in violation of the due-on clause;
- starts foreclosure to enforce a call under the due-on clause; or

- fails during the pendency of the sale of property subject to the loan to approve, within 30 days of receipt of the completed credit application from a qualified buyer, the assumption of the loan or carryback note. [12 Code of Federal Regulations §591.5(b)(2), (3)]

However, a seller carrying back a note secured by a one-to-four unit residential property can **bar prepayment** only for the calendar year of sale, if he has not already carried back more than three notes in the same year. [CC §2954.9(a)(3)]

The five-year prepayment penalty rule which applies to buyer-occupants of one-to-four residential units does not apply to **investors** who buy one-to-four unit residential properties or any other property.

After the calendar year lock-in period expires, the one-to-four unit investor can **pay off** the carryback note at any time, subject to any reasonable, agreed-to prepayment penalty. [CC §2954.9(a)(1), (2)]

The prepayment penalty included in a seller carryback note secured by one-to-four residential units (or any other investment property) and **executed by an investor** can be set at 25% of any principal prepaid to cover the seller's potential state and federal profit tax liability on early payoff. Thus, the carryback seller's potential profit tax liability on an early payoff of principal on a note executed by an investor who bought the property can be fully recovered. The investor is not a buyer-occupant and the property is not one-to-four residential units. [CC §2954.9(a)(2), (3)]

A 25% bonus for the seller

A seller of real estate, other than a one-to-four unit residential property to be acquired by a buyer/occupant, informs his broker he will carryback paper for a substantial portion of the property's sales price after a 20% down payment.

The seller is aware the **profit** in the carryback note will not be taxed until principal is received or the note is assigned by sale or as collateral, called *hypothecation*.

The seller's broker determines the seller's remaining **cost basis** for the property is less than the balance of the trust deed lien on the property. Thus, the entire amount of the carryback note on an installment sale will be profit, subject to taxes as principal is paid, due to the seller's *mortgage-over-basis* situation.

If the seller were to receive cash, and thus be taxed on all of his profit in the year of the sale, he would pay a combined federal and California state income tax of approximately 25% of his profit (2009). Here, his profit consists of depreciation produced *unrecaptured gain* (25% federal tax for 2009) and value increased *long-term capital gain* (15% federal tax rate for 2009).

If the seller were to cash out at the time of sale, he would deposit the balance of his net proceeds remaining after the payment of taxes in an interest-bearing account. Thus, he would receive interest earnings on less than 75% of his equity, the other 25% being disbursed (in cash) to pay state and federal profit taxes.

However, with taxes deferred until later years by an installment sale, the seller will earn interest (at the carryback note rate) on the full amount of his equity remaining unpaid after the down payment.

Thus, the seller is motivated to **defer taxes** on his profit until the carryback note is due in, for example, five years. Meanwhile, the seller will earn interest on the amount of the profit tax he retains as principal in the carryback note.

Compensation for an early payoff

To accomplish the goal of earning interest income for a five-year period on that portion of the sales price which will eventually be paid as profit taxes, the broker presents the carryback seller with two alternatives:

- lock in the buyer to payments of no more than the scheduled installments by eliminating the "or more" provision in the note and prevent early payoff of additional principal; or

- include provisions in the note for a prepayment penalty to be due on the payoff of any principal in addition to scheduled installments.

The seller selects the prepayment penalty alternative after the broker voices concern over the enforceability of a *lock-in clause*. Deletion of the **or-more clause** prohibits principal reductions except under regular monthly payments and the final/balloon payment.

The seller and his broker agree to include a prepayment penalty in all negotiations. A 25% penalty on the payoff of any principal not included in regular monthly payments is estimated to be sufficient to cover the income taxes due on an early payoff of the note.

Can a carryback seller enforce a prepayment penalty in the amount of the estimated tax he will pay on his profit should the buyer pay off any additional principal within five years?

Yes! A prepayment penalty is enforceable if the penalty amount is reasonably related to the carryback seller's **anticipated money losses** for the premature payment of profit taxes likely to be incurred due to a prepayment of part or all of the principal on the carryback note.

Since the anticipated amount of profit taxes to be paid on an unscheduled principal reduction is the amount of the penalty, a 25% penalty on the prepayment of remaining principal is reasonable. [**Williams** v. **Fassler** (1980) 110 CA3d 7]

A prepayment penalty provision in a note secured by property other than buyer-occupied, one-to-four unit residential property is enforceable if the amount of the penalty is reasonably related to the note holder's loss.

Reasonableness of the penalty

The reasonableness of the penalty amount is tested **at the time** the note and trust deed are entered into, not years later on payoff when interest and tax rates may have gone through major fluctuations, either up or down. [Williams, *supra*]

Although a prepayment penalty inhibits conveyancing and reconveyancing, it is considered to be a **reasonable restraint** on the owner's use of his title, a use called *alienation*. [Sacramento Savings and Loan Association, *supra*]

An exorbitant or unconscionable penalty is unreasonable and cannot be enforced. The courts are here to monitor the amount of prepayment penalties to ensure they are reasonable. [Hellbaum, *supra*]

Consider a borrower who enters into a loan transaction with a lender. The borrower later prepaid the principal of the note. In determining the amount of interest needed to satisfy the obligation, the lender calculated interest for February, a short month, as one-twelfth of a year, roughly 30.4 days.

The borrower claims the lender's calculation of interest breached the terms of the note since it calculated interest on the basis of a 30.4-day month not the literal days in the month, and thus the lender was guilty of unfair business practices.

Can the lender enforce the prepayment penalty using the 30.4-day month calculation?

Yes! Even though February is shorter than 30.4 days, the lender can use the 30.4-day month interest calculation for determining the loan payoff since that method of calculation was consistent with the industry standard, federal regulations and a reasonable interpretation of the terms of the note. [**Julie Puentes et al** v. W**ells Fargo Home Mortgage, Inc.** (2008) 160 CA4th 638]

Thrifts and government lending programs

Federal savings associations, called *thrifts*, may charge agreed-to prepayment penalties on owner-occupied, one-to-four unit residential property. [12 CFR §560.34]

Further, since federal regulations control thrifts, the California five-year limit for prepayment penalties on owner-occupied homes does not apply unless agreed to by both the borrower and federal savings association.

For loans insured by the Federal Housing Administration (FHA) and Veterans Administration (VA), a prepayment penalty is not charged on early payoff. Instead, unearned interest to the end of the month of payoff is charged. [24 CFR §203.22(b); 38 CFR §36.4310]

Also, as a policy, the Federal National Mortgage Association (Fannie Mae) does not usually enforce the prepayment provisions of most conventional single family residence (SFR) loans. However, Fannie Mae will enforce a prepayment penalty provision if the loan is an adjustable rate note, second mortgage, or participation pool first trust deed.

The policy of the Federal Home Loan Mortgage Corporation (Freddie Mac) is not to charge prepayment penalties if it will hurt the consumer.

Many SFR loans originated for sale in the secondary mortgage market do not contain prepayment penalty clauses. Inquiry should be made into the inclusion of penalty provisions in the loans secured by the listed property.

Penalty enforced by foreclosure

Consider an owner who defaults on both the first and second trust deeds on his property. The default is not related to a failure to pay a call triggered by the due-on clause.

The first trust deed contains a prepayment penalty clause. The clause calls for payment of the penalty whether the note is *voluntarily* (i.e., refinance) or *involuntarily* (i.e., foreclosure) paid off before the final payment is due. The first trust deed lender records a Notice of Default (NOD) calling the note due, and ultimately records a Notice of Trustee's Sale (NOTS).

In the NOTS, the amount to pay off the loan includes:

- any unpaid principal balance;
- all accrued and unpaid interest;

- all late charges;
- all foreclosure costs (including attorney and trustee's fees); plus
- a prepayment penalty as agreed to in the note.

Neither the borrower nor the second trust deed lender *reinstate* the loan prior to five business days before the trustee's sale. Also, the second trust deed lender elects not to *redeem* the property. Instead, he decides to bid on it at the trustee's sale on the belief the penalty cannot be included in the bid since the loan is now due by the lender's enforcement of its terms.

At the sale, the first trust deed lender includes the prepayment penalty in its bid.

Can the first trust deed lender demand and collect a prepayment penalty charge at the trustee's sale?

Yes! The first trust deed lender's right to collect a prepayment penalty charge, unless the amount is limited by statutes, is set by the provisions of the note. Since the note provides for a prepayment charge whether the loan is **voluntarily or involuntarily** prepaid, the second trust deed lender or any other bidder at the trustee's sale must pay the penalty charge as part of the trustee's sale price. [**Golden Forest Properties, Inc.** v. **Columbia Savings and Loan Association** (1988) 202 CA3d 193]

However, when the note or trust deed limits a prepayment penalty charge to only **voluntary payoffs**, the first trust deed lender cannot include the charge when the property is redeemed or bid on at the trustee's sale. Many pre-1983 notes and trust deeds do not give the lender the right to collect a prepayment penalty when the lender called the loan and forced an involuntary payoff. [**Tan** v. **California Federal Savings and Loan Association.** (1983) 140 CA3d 800]

Prepayment penalty triggered by late payments

Now consider a lender who holds a note secured by a trust deed on real estate other than an owner-occupied, one-to-four unit residential property. The note contains a prepayment penalty provision which states a charge of six months unearned interest will be due on any payoff within six months after the origination of the loan.

The provision also states the prepayment penalty will be due on a later payoff if any regularly scheduled payment is delinquent when paid. The owner makes a regular payment after the grace period had expired.

After the initial six months, the owner prepays the loan together with the prepayment penalty demanded by the lender.

The owner claims the prepayment penalty is an unenforceable *liquidated damages* penalty since the penalty was imposed based on a late payment of a regular installment, not the amount prepaid, and was unrelated to losses the lender incurred on prepayment of the loan.

Can the lender enforce a prepayment penalty on a final payoff which was triggered by a late payment?

No! The prepayment penalty here is worded as a penalty for having paid a regular installment late. Thus, the purported prepayment provision becomes an unenforceable **liquidated damages** provision. The pre-

payment penalty on payoff was triggered by the owner's late payment of a regular installment, not the prepayment. Thus, the amount of the penalty bore no relation to the lender's losses due to the late payment. [**Ridgley** v. **Topa Thrift and Loan Association** (1998) 17 C4th 970]

Prepayment penalty due on a call

Consider a prepayment penalty clause in a seller carryback note which allows the seller to collect a penalty on **voluntary or involuntary prepayment** of the debt.

The buyer defaults on the trust deed. The seller calls the note due, demanding a prepayment penalty for full satisfaction and reconveyance of the debt.

The buyer tenders full payment of the debt excluding the prepayment penalty, which the carryback seller refuses.

The buyer claims the prepayment penalty clause is unenforceable since the penalty can only be applied when the buyer **voluntarily** prepays the debt.

The seller claims the prepayment penalty clause is enforceable since the penalty provision allows the seller to demand a prepayment penalty whenever the note is called.

Is the prepayment penalty clause enforceable when the note is called?

Yes! The prepayment penalty clause is enforceable on the note holder's acceleration of the debt. The clause permits the seller to demand a prepayment penalty on an involuntary prepayment resulting from the seller's acceleration of the balance due on the note, unless the call resulted from the seller's exercise of the due-on clause. [**Biancalana** v. **Fleming** (1996) 45 CA4th 698]

Chapter 10 — Loan lock-in clauses

This chapter addresses the lender's and carryback seller's need to avoid loan lock-in clauses and use prepayment penalties instead.

Restraints on rights of alienation

A builder obtains a long-term permanent loan from a lender to finance his development and continued ownership of non-residential real estate or an apartment project. The loan is secured by a trust deed on the property. The trust deed note contains a *lock-in clause* prohibiting prepayment of the debt for the first 7 years of the loan. The note also contains a **prepayment penalty** which applies to any principal paid off during or after the 7-year lock-in period.

The loan originates during tight money market conditions when long-term interest rates are at a cyclical high (and construction costs are low).

Later, during the 7-year lock-in period, interest rates drop significantly. Wanting to take advantage of the lower market rates to refinance the property, the builder requests a payoff demand from the lender and a reconveyance of the trust deed lien.

However, the lender refuses to allow a payoff and reconveyance. The lender claims the builder is locked in for the first 7 years of the loan by contract which **bars prepayment and reconveyance** at any time during the lock-in period.

The builder claims the lock-in clause and the prepayment penalty are in conflict with one another, which allows him to pay off the loan provided he pays the prepayment penalty called for *on a default* during the lock-in period.

Is the builder prohibited from prepaying the locked-in loan?

Yes, according to contract law! The builder has agreed to be locked into the loan absolutely for the period agreed to in the note. The provision prohibiting prepayment, and the duration of the prohibition, was stated in the loan documents. Thus, the builder was aware of the provision barring prepayment, which he freely agreed to. [**Trident Center** v. **Connecticut General Life Insurance Company** (9th Cir. 1988) 847 F2d 564]

Enter real estate law for the greater good

However, a real estate matter of public concern exists in the *Trident Center* fact situation which was not addressed. The lock-in provision contained in the loan documents completely restricts the owner's right to **freely reconvey** and re-encumber his interest in a parcel of real estate.

When applying real estate law, a lock-in clause becomes an unenforceable *restraint on alienation*. A prohibited prepayment of debt and reconveyance of the trust deed lien from title is an absolute interference with the right to clear his title and transfer a security interest in real estate to another lender.

When a provision which functions as a restraint on alienation is unnecessary to protect the lienholder's security interest in the property against the risk of loss, it is unreasonable and unenforceable under real estate law. A payoff eliminates any risk of loss and any need for the lender to protect its security interest in the property. [Calif. Civil Code §711]

Also, an owner's right to a reconveyance can be significantly **inhibited** by the financial impact of a prepayment penalty. However, the monetary penalty for prepayment is not considered in real estate law to be an unreasonable restraint. Under a prepayment penalty, the owner has the ability to obtain a reconveyance and clear title of the lender's security interest in the property, albeit at a high cost in terms of money expended.

A prepayment penalty does not bar the reconveyance which clears title of the lender's security interest. It only makes a borrower's payoff on a demand for payoff more financially difficult.

Unlike a lock-in clause, the monetary **prepayment penalty**, though an economic constraint, still allows for the *voluntary use* of the property by the owner, whether it be a further encumbrance or a sale. [**Sacramento Savings and Loan Association** v. **Superior Court** (1982) 137 CA3d 142]

Conversely, the lock-in clause absolutely bars the owner from obtaining a reconveyance to clear his title and re-encumber his property. Thus, the lock-in clause is void under real estate law since the lender experiences no risk of loss on a payoff, either by impairment or default, which would give him the right to restrict the use of ownership rights. Lenders claim that without the lock-in provision they lose the expectation of the interest to be earned on the note, but this expectation is covered by the prepayment penalty.

However, recent judicial decisions, such as those in *Trident Center*, have attempted to resolve restraints on alienation based solely on general contract law theories, rather than under the historic judicial preference to apply more specific rules controlling interference with an owner's interest in real estate.

Public policy breach

Trident Center rests solely on the **contract doctrine** that a restraint on alienation provision is valid if it is willingly entered into between an owner and a lender of relatively equal and sophisticated bargaining power.

However, **real estate law**, which is the foundation for real estate rights, prohibits unreasonable restraints on alienation no matter how contracted, or how aggressively the lender bargains to achieve an agreement from the borrower consenting to the restraint. The lock-in, as a contractual provision, attempts to trample ancient **public policy** which demands title remain unfettered and available to the real estate marketplace.

The prohibition of restraints on transfers of real estate interests gives property owners the right to voluntarily use or convey the many ownership rights and interests held in their real estate. This right is subject to lender interference only when it is necessary for the lender to protect himself from an increased risk of loss and interference by third parties holding involuntary liens, such as the Internal Revenue Service (IRS). [**Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423]

The owner's right to use his ownership interests, in spite of contractual provisions to the contrary, is historically long-standing. Court decisions imposing contract law theories to override the pre-existing statutory rights of owners to alienate real estate now jeopardize the property owners' right to freely transfer encumbered property in the real estate marketplace.

Contract law vs. real estate law

A seller carries back a note secured by a trust deed on the sale of his income producing property.

A boilerplate provision in the trust deed allows for prepayment of the note, subject to an early payoff penalty.

However, the trust deed note includes an additional typewritten provision which states the buyer is locked in to making monthly installments, and is prohibited from prepaying the note prior to its due date. Also, the "or more" clause is not stricken from the boilerplate provisions in the note.

Thus, the carryback note and trust deed include **conflicting provisions**, two in the printed form which permit prepayment and a reconveyance of the property without penalty, and one added to the printed note form which prohibits prepayment and reconveyance entirely.

The buyer, after making payments on the note, attempts to pay off the note prior to its due date.

The seller claims the addition of the lock-in clause in the note prohibits prepayment since the buyer agreed to the provision, which has authority over conflicting preprinted provisions.

The buyer claims the lock-in clause is unenforceable since the boilerplate and additional provisions in the note are inconsistent, allowing prepayment and reconveyance limited only to the payment of a monetary penalty.

Can the buyer be completely prohibited from prepaying the note, even though the boilerplate provision in the note provides for prepayment?

Yes! Under contract law, the buyer can be prohibited from prepaying the note.

When preprinted boilerpate provisions and additionally entered provisions in a set of documents are in conflict, the **added provisions control**. Thus, even if a provision allowing prepayment is located in the boilerplate provisions of a note, the additionally entered lock-in clause, which is in conflict, controls under contract law theory. [**Gutzi Associates** v. **Switzer** (1989) 215 CA3d 1636; CC §1651]

Restraints vs. the need to protect

However, under the more specific real estate law, any lock-in provision prohibiting the release of real estate interests is a restraint on alienation. The *Gutzi* case agreed, but held the restraint was *reasonable* since the property owner failed to demonstrate the unreasonableness of the interference. No request for payoff was ever made on the lender by the owner and no interference actually occurred.

The *quantum of restraint* on the sale or refinance of real estate necessary for the provisions in a note or trust deed to be unenforceable under real estate law is **weighed against** the lender's need to protect its investment from a risk of loss.

A contracted for lock-in clause becomes an unreasonable restraint on alienation if it causes transferable real estate rights to be unavailable to the marketplace under any present circumstance. [**Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488]

The owner's ability to reconvey a lender's security interest, while concurrently encumbering the property by recording a trust deed to another lender with the same priority on title, or transferring the property to a cash buyer, is directly and absolutely barred by a lock-in clause.

When a lock-in clause imposes a restraint on an owner's right to reconvey and release liens of record, and this imposition cost is greater than that experienced by the lender due to an early payoff, the lock-in clause is an unenforceable provision.

Enforceable vs. unenforceable restraints

Prepayment of real estate loans is allowed, regardless of provisions in a note and trust deed prohibiting early payoff, when:

- the note is secured by four-or-less, owner-occupied residential units [CC §2954.9(a)];
- the note has a variable interest rate and on notification of a change in the rate, the borrower may prepay within 90 days [CC §1916.5(a)(5)];
- the debt is a land sales contract which provides for land to be subdivided into lots of four-or-less residential units [CC §2985.6(a)];
- the prepayment penalty clause is not sufficiently specific to allow enforcement [**Donahue** v. **LeVesque** (1985) 169 CA3d 620]; or
- the property subject to a trust deed is acquired for public use. [Calif. Code of Civil Procedure §1265.240]

Conversely, a lock-in clause is enforceable in two limited **carryback situations** when necessary to assure installment sales profit tax treatment. For example, the buyer of four-or-less residential units can only be locked into the trust deed note and barred from prepayment during the **calendar year** of sale. [CC §2954.9(a)(3)]

After the lock-in period expires, the buyer has the right to pay off the note at any time, subject to the prepayment penalty agreed to and as limited by law. [See Chapter 13]

The other is the repayment of a seller carryback documented as a land sales contract on four-or-less residential units which can be prohibited for up to a 12-month period following the sale. [CC §2985.6(a)]

Carrybacks and the lock-in

A carryback seller's primary motivation for locking in the buyer is his desire to prevent the seller's premature payment of profit taxes which would be due on an early payoff of the note.

Carryback sellers **reporting profits** on the installment sales method limit their taxable profit in any one year to the pro rata share (contract ratio) of profit in the principal paid on the note. The installments received each year on a carryback note typically include only a small amount of principal. Thus, use of a lock-in clause bars early payoff of principal, one method for allowing the seller to take full economic advantage of the tax deferral in **installment sales reporting**. [Internal Revenue Code §453; see Chapter 54]

However, the carryback seller's protection from premature reporting of profit and the resulting tax liability is not best remedied with the problematic lock-in clause, but by inclusion of the judicially acceptable prepayment penalty provision. [**Williams** v. **Fassler** (1980) 110 CA3d 7]

Lenders and lock-ins

For lenders, a lock-in clause is a portfolio tool to assure a consistent, long-term yield on a loan, regardless of actual market rate fluctuations during the life of the loan.

Locking in the borrower to prevent early payoff of loans made during periods of expected high future inflation and high interest rates is the lender's long-term profit motive. As cyclical inflation is inevitably broken by government monetary policy, the *real rate* of return to the lender, and thus real earnings, increases on the old fixed-rate loan.

As inflation abates, the lock-in clause protects the now excessive **real rate** of return, an economic distortion delivering a **windfall profit** to the lender due solely to government monetary policy moves. The profit in the lender's portfolio yield is the spread between the rate of inflation (cost of funds) and the note rate. As an exaction to enforce a right to protect a loan from loss, portfolio yield interference has been denounced in California as being beyond the legitimate purpose of a trust deed lien on real estate. [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]

Editor's note — A ***real rate of return*** *is the difference between the rate charged on the loan and the present rate of inflation. Thus, the note rate the lender receives is broken down into the inflation rate and a real rate of return.*

Chapter 11 Late charges and grace periods

This chapter analyses the purpose of late charge provisions in trust deed notes and limitations on their enforcement by carryback sellers and private lenders.

Related amounts are enforceable

A seller carries back a note and trust deed on the sale of any type of real estate. The note calls for his buyer to pay periodic installments by the first day of each consecutive month commencing the month first following 30 days after the close of escrow, called the *payment due date*. The note also calls for the debt to be paid in full seven years from the close of escrow, called a *final balloon payment*.

Further, the note contains a **late charge provision**. It states that for a period of ten days following the due date for a payment it may be delivered before the seller may impose a late charge, called a *grace period*. If a past-due payment is not yet received by the seller before the grace period expires, the payment is then considered *delinquent*.

When an installment becomes **delinquent**, the late charge provision calls for the note rate of interest accruing on the principal amount of the entire remaining debt to be increased by 2% (200 basis points) and accrue thereafter until the delinquency is cured, an arrangement called a *default rate.*

The seller does not receive an installment before it becomes delinquent. The seller makes a **written demand** on the buyer to pay the delinquent installment, together with a daily amount equal to the 2% additional interest on the entire principal balance as the late charge until the seller receives the delinquent installment. The additional interest accrues on a per diem basis between the expiration of the grace period and seller's receipt of the delinquent installment.

The buyer tenders the delinquent payment, but refuses to pay the late charge. The buyer claims the default rate provision is an unenforceable *liquidated damages provision* — a penalty — since the amount exceeds the out-of-pocket money losses the seller incurred due to the delinquency of an installment.

The seller claims the late charge is enforceable since the buyer agreed to the charge in the note and the actual costs incurred by the seller in his efforts to collect the delinquent payment are difficult to ascertain.

Can the seller enforce the default rate late charge provision in the note?

No! As a late charge, the amount is unreasonable and thus unenforceable. The provision is an attempt to impose a penalty which is triggered by the delinquency in the payment of a scheduled installment. However, the amount of the late charge for the delinquency is calculated as a rate of interest accruing on the **entire debt**, not limited to interest on the amount of the delinquent principal and interest payment for which collection is sought. Thus, the late charge is based on amounts owed, but not yet due or delinquent.

For all notes secured by any type of real estate, a late charge provision calling for the charge to be calculated as a rate of interest on the entire principal balance to ascertain the amount of the late charge incurred for the delinquency of a monthly installment, is a *disguised penalty provision.*

Disguised penalty provisions are void and thus unenforceable. To be enforceable, the noteholder's compensation under a late charge provision is limited solely to his out-of-pocket **monetary losses** caused by the delinquency in the payment. No wild-fall profits can be taken when a payment is delinquent. [**Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731]

Elements of a late charge

To establish the right to enforce collection of a late charge, the following conditions must be met by the noteholder:

- a **late charge provision** exists in the note [See Form 418-1 accompanying this chapter];
- a scheduled payment is **delinquent**;
- a **notice of amounts due** is delivered to the payor assessing the late charge and demanding its payment [See **first tuesday** Form 419-2];
- the **dollar amount** of the late charge is within the limits set by applicable lender statutes and *reasonableness standards*; and
- **accounting requirements** for semi-annual and annual reports have been complied with. [See **first tuesday** Form 419-3]

The failure of an owner to pay a late charge of a proper amount and for which a demand has been made on the delinquency of a payment is a *non-material breach* of the note and trust deed. As a non-material breach, the failure to pay late charges cannot be the sole monetary basis for initiating a foreclosure by recording a notice of default (NOD).

Distinctions exist in the treatment of late charges permitted for private lender loans as compared to charges permitted for seller carryback paper. For private lenders, late charges on loans **secured by single family residences** (SFRs) are treated differently than when they are secured by other types of property. Also, the amount of the late charge a private lender may impose is further controlled by whether or not the loan was **made or arranged** by a broker.

The negotiation of late charge provisions

Late charge provisions are included in all notes used by **institutional lenders**. Late charge provisions sought by institutional lenders are generally non-negotiable, due primarily to lender adherence to established uniformities, such as ceilings set by statute or pooling arrangements in the secondary mortgage money market. However, the inclusion of late charge provisions in notes carried back by **sellers** or originated by **private lenders** is never automatic and is left to negotiation.

Before a late charge provision is included in a note, the charge must be agreed to. When the late charge is one of the carryback note provisions agreed to in a **purchase agreement**, it is then proper for escrow to be instructed to include the applicable late charge provision in the note prepared for signatures. [See **first tuesday** Form 150 §8.1]

LATE PAYMENT PROVISIONS

Addendum to Promissory Note

DATE_____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____________, 20______, at ______________________________, California,

1.2 entered into by ____, as the Payor,

1.3 in favor of ____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as ____

____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For an owner-occupied, single family residence*:

☐ Any installment on this note not received within 10 days after the due date is delinquent and will incur a late charge, on demand, in the sum of 6% of the delinquent principal and interest installment amount.

2.2 *For a broker-made/-arranged loan on any property* [Calif. Business and Professions Code §10242.5(a)]:

☐ Any installment on this note not received within 10 days of the due date is delinquent and will incur a late charge, on demand, in the sum of 10% of the delinquent principal and interest installment amount.

2.3 *On other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If any installment on this note is not received ☐ when due, or ☐ within ______ days of the due date, the installment will be delinquent and will incur a late charge, on demand, in the sum of ☐ $_______________, or ☐ ______% of the delinquent principal and interest installment amount.

2.4 *For a broker-made/-arranged loan on any property, final/balloon payment late charge* [Calif. Business and Professions Code §10242.5(c)]:

☐ If the final/balloon payment due on this note is not received within 10 days after the due date, the final/balloon payment will be delinquent and will incur a late charge on the delinquency and thereafter, on demand, for each month the final/balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.

2.5 *For a balloon payment late charge on other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If the final/balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue at the rate of ______%.

2.6 *For compounding interest on a default on other than one-to-four residential units*:

☐ On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are received.

Payor's name ________________________________

Signature ___________________________________

Payor's name ________________________________

Signature ___________________________________

Payor's name ________________________________

Signature ___________________________________

Payor's name ________________________________

Signature ___________________________________

FORM 418-1 03-08

The provision and the late charge amount

For a late charge provision to be complete, it must include:

- the **amount** of the late charge;
- the **duration of any grace period** following the due date before a payment becomes delinquent; and
- a **requirement for notice** from the trust deed holder to impose – assess – the late charge and make a demand for its payment. [See Form 418-1]

The amount of a late charge imposed on the delinquency of a payment on a debt secured by real estate, except private loans secured by an owner-occupied single family residence (SFR) or loans made or arranged by a broker, must be *reasonably related* to money losses incurred by the creditor (carryback seller and non-SFR private lenders) due to the delinquency. [Calif. Civil Code §1671; see Form 418-1 §2.3]

While late charge provisions are triggered by the delinquency of a periodic payment or the final/balloon payment, the late charge agreed to is not automatically due. Unless the delinquency is immediately preceded or followed by a notice imposing the charge and demanding its payment, the charge is *waived*. [CC §2954.5]

The reasonable amount of **monetary losses** collectible as a late charge include:

- the actual *out-of-pocket expenses* incurred in a reasonable collection effort; and
- the *lost use* of the principal and interest (PI) portion of the delinquent payment.

Money losses incurred in a reasonable effort to collect a late payment include the cost of forms, envelopes and postage for mailing the notice, and the administrative time spent by individuals to do so prior to recording a notice of default (NOD).

Even if the late charge provision is void as excessive and constituting a financial windfall to the carryback seller or private lender, the buyer is still liable for the seller's or lender's out-of-pocket money losses resulting from the delinquency, if assessed and payment demanded. [Garrett, *supra*]

When a scheduled payment is not received prior to its becoming delinquent, a late charge provision in an installment note properly calls for either:

- an additional one-time fixed fee stated as a dollar amount; or
- the accrual of interest on the amount of the delinquent PI payment.

For example, a one-time late charge takes the form of a **flat fee**, such as $50.00, or a **percentage** of the monthly PI installment, such as 6%. Infrequently, a late charge is disguised as an unenforceable default interest rate charged on the entire principal, as presented in this chapter's opening example.

Fundamentally, any formula or percentage figure used to determine the amount of a one-time late charge is questionable. A lender is only entitled to be reimbursed for his costs and efforts of collection. When a formula or percentage figure is used in larger loans to calculate the amount due they are suspect since the

issue of *unjust enrichment* for the lender arises. The same amount of time, effort and funds are expended in the collection of a delinquent payment on a $50,000 loan as are expended on a $500,000 loan, but use of the same formula or percentage for each imposes a hugely different and greater dollar amount on the larger loan involved. [Garrett, *supra*]

Late charge notice

To collect a late charge for the delinquent payment on a note secured by **any type of real estate**, the carryback seller or private lender holding the note must notify the property owner of the charge and **make a demand** for its payment.

Private lenders must give notice and make a demand for the late charge in a *timely manner* by use of either:

- a billing statement or notice sent for each payment prior to its due date stating the late charge amount and the date on which it will be incurred; or

- a written statement or notice of the late charge amount due concurrent with or within ten days after mailing a notice to cure a delinquency. [CC §2954.5(a); see **first tuesday** Form 419-2]

The notice of amounts due or the billing statement, whichever is used, must include the exact amount of the late charge or the formula used to calculate the charge. [CC §2954.5(a)]

If the private lender fails to initiate collection of the late charge for any delinquency by a notice and demand for its payment, the lender **waives** his right to collect a late charge on that payment. However, failure to comply with the late charge notice requirements on a delinquency does not waive the private lender's right to enforce the late charge provision on future delinquencies. [CC §2954.5(e)]

In regards to **carryback notes**, if, on receipt of a delinquent payment, the carryback seller fails to make a demand for payment of the late charge, he waives his right to collect a late charge on that installment. [Calif. Code of Civil Procedure §2076; CC §1501]

However, a carryback seller who continually waives his right to collect a late charge by failing to impose late charges must give the buyer an advance notice of his intention to reinstate the late charge provisions and demand a late charge on future installments should they become delinquent.

The right to enforce the grace period and late charge on future delinquencies must be **reinstated by a timely notice** of the beneficiaries intent to use the provision. A 30 day notice before taking action is considered timely. [**In re Hein** (9th Cir. 1986) 60 BR 769; CC §2954.5(b), (e)]

Late charges on SFRs

A private lender makes a loan to a homeowner secured by his single family residence (SFR) he occupies as his principal residence. The note calls for monthly installments of principal and accrued interest (PI) to be paid on the first day of each month. The loan is not made or arranged by a broker.

The note contains a **late charge** provision allowing:

- a ten day grace period after the due date for the lender to receive each monthly payment before it is delinquent; and

- a late charge of 6% of the delinquent PI installment on written notice and demand for its payment. [See Form 418-1 §2.1]

A monthly payment is not received on or before the eleventh day of the month, the expiration of the ten day grace period on the tenth day after the due date.

The lender sends the homeowner a **written notice** of amounts due demanding payment of the delinquent installment and the agreed-to 6% late charge. [See **first tuesday** Form 419-2]

The homeowner makes the delinquent payment but refuses to pay the late charge.

Is the private lender's demand for the late charge enforceable?

Yes! The installment was **not received** by the expiration of the ten day grace period following the due date of the installment. Thus, it is delinquent and a late charge is collectible on notice and demand.

Ten days is the **minimum grace period** allowed for a private lender secured by an owner-occupied SRF, even if the homeowner agrees to a shorter grace period, or no grace period is agreed to. [CC §2954.4(a), (b)]

The late charge amount on a private lender loan which is **not made or arranged** by a broker and is secured by an owner-occupied SFR is limited to the greater of:

- 6% of the delinquent principal and interest installment; or

- $5. [CC §2954.4(a), (e)]

What if the payment was post-marked as mailed within the grace period but was received by the lender after the grace period expired?

Mailing the installment within the grace period does not qualify the payment as timely paid. The payment must be **actually received** by the carryback seller, lender or collection agent no later than the last day of the grace period and be immediately negotiable. [**Cornwell** v. **Bank of America National Trust and Savings Association** (1990) 224 CA3d 995]

Conversely, the note may require the owner to tender the payment by employing a particular method of payment, such as by mail. Then the payment is considered received when the owner complies with the method of payment, such as placing the payment in the mail, even if the noteholder never receives it. [CC §1476]

Made or arranged by brokers

When a licensed real estate broker makes or arranges a loan as or for a private lender, the 6% limit for late charges established for loans secured by owner- occupied single family residences (SFRs) does not apply, nor do other reasonableness standards. [CC §2954.4(e)]

For private lender loans **made or arranged** by a real estate broker, called a *brokered loan*, and secured by any type of real estate, the late charge is limited to the greater of:

- 10% of the delinquent principal and interest payment; or

- $5. [Calif. Business and Professions Code 10242.5(a); see Form 418-1 §2.2]

Also, if the private lender loan made or arranged by a broker contains a due date for a **final/balloon payment**, a late charge may be assessed on the final/balloon payment if it is not received within ten days after its due date. [See Form 418-1 §2.4]

The amount of the late charge assessed on a delinquent final/balloon payment for a brokered loan is limited to the amount of the 10% late charge due (calculated) on regularly scheduled monthly installments. However, the late charge on a final/balloon payment for a brokered loan may be **charged for each month** the payment remains delinquent. In addition, interest at the note rate (or default or statutory rate) accrues and is payable with the final/balloon payment. [Bus & P C §10242.5(c)]

Like an owner-occupied SFR loan, an installment on a private lender loan made or arranged by a broker on any type of property is not late if paid (received by the lender) within ten days after the installment is due. [Bus & P C §10242.5(b)]

One charge per delinquency

For a private lender loan secured by an owner-occupied single family residence (SFR), or one made or arranged by a broker and secured by any type of property, the private lender cannot charge more than one late charge per delinquent monthly installment, no matter how many months the payment remains delinquent. [CC §2954.4(a); Bus & P C §10242.5(b)]

For example, a homeowner fails to make the January and February installments on a loan made by a private lender and secured by an owner-occupied SFR whether or not the loan was arranged by a broker.

The private lender charges the homeowner a late fee for each month a payment remains delinquent, demanding two late charges for the January payment and one for the February payment.

The homeowner pays one installment in March before the grace period expires.

The lender's accounting program applies the payment to the delinquent principal and accrued interest (PI) installment due in January, and demands payment of additional late charges for the failure to timely pay the February and March installments.

However, the lender may only collect two late payment charges, no matter how many months pass before catching up the **missed payments**, one for the January installment and one for the February installment (both of which still remain unpaid), and none for March since the March installment was timely paid. [CC §2954.5]

A payment received in the month following a delinquent and unpaid installment is deemed to be receipt of the **most recent payment** due on the loan, not payment of the most outstanding delinquent installment. Thus, for a series of payments which are always one month late, only one late charge is permitted by the lender over the entire period since only one installment has been missed. The charge is for the one missed installment which still remains unpaid by the homeowner. [CC §2954.4(b); Bus & P C §10242.5(b)]

However, for accounting purposes, funds from the most recent payment are applied to the interest accrued for the month of the oldest delinquency.

The statutory *one-delinquency, one-charge* rule does not apply to carryback sales even if the carryback note is negotiated by a broker.

Final/balloon payments untimely paid

When a **final/balloon payment** on a loan or an installment sale becomes delinquent, a private lender or carryback seller may enforce a *default rate* provision. A default rate increases the note rate on the remaining principal, unless the debt is secured by an owner-occupied single family residence (SFR) or is a broker-arranged loan. [**Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701]

However, the default rate of interest must be reasonable and triggered only by the expiration of any grace period for delivery of the final payment. [Garrett, *supra*; see Form 418-1 §2.5]

Impound accounts

An *impound account* is a money reserve, also called an *escrow account*. The money in the account consists of the funds that the property owner advanced to the lender or carryback seller as an initial deposit, followed by regularly scheduled further deposits. From the impounded funds, the lender or carryback seller pays specified obligations the owner periodically owes on the property, such as:

- property taxes;
- insurance premiums;
- assessments for common area or easement maintenance;
- water stock; or
- bonded off-site improvements.

To fund the **impound account**, a pro rata amount of the costs anticipated to be incurred to pay annual taxes, assessments and insurance premiums (TI), is collected each month along with the monthly principal and interest (PI) payments (PITI). [See Chapter 16]

For late charge purposes, the tax and insurance portion - **impounds** - of the owner's monthly PITI payment must not be included in the formula for computing the amount of the late charge. The TI funds are the owner's money, accumulated by the carryback seller to pay obligations owed by the owner to others.

Enforcement of the late charge

Refusal or failure of an owner to meet a demand to pay a late charge agreed to in a trust deed note is a *non-material breach* of the note and trust deed. Thus, non-payment of a late charge by itself does not justify a call of the loan or initiation of foreclosure. [**Baypoint Mortgage Corporation** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

No lender or carryback seller is entitled to foreclose on an owner who has tendered all installments which are due, but has failed to pay outstanding late charges. Collection of late charges when no other monetary breach exists must be enforced by means other than foreclosure.

Additionally, a private lender making a loan on any type of real estate is required to furnish the owner with a **semi-annual accounting** for the total amount of late charges due and unpaid during the accounting period. [CC §2954.5(b); see **first tuesday** Form 419-3]

For late charges on a carryback note secured by property improved with only a one-to-four unit family residence, the carryback seller must also provide the owner with an **annual accounting** statement detailing any late charges due and unpaid during the entire year. [CC §2954.2(a); see **first tuesday** Form 419-3]

Consider an owner of real estate who is delinquent on his January payment for a loan made by a private lender and secured by his property. A timely notice and demand is made by the private lender for payment of the late charge. Before the grace period for the February payment expires, the private lender receives an amount equal to one installment.

Can the private lender reject the owner's principal and interest (PI) payment since the payment did not include the late charge or the past payment?

No! The private lender must accept the owner's installment. Further, if the late charge is not paid, the lender must notify the owner every six months of the outstanding unpaid late charges if he is to eventually enforce collection of the unpaid late charges. [CC §2954.5(b)]

A court action to collect the late charge is not advisable. An action would violate the *one-action rule* and cause a forfeiture of the trust deed lien since the late charge is part of the debt originating under the terms of the note and secured by the trust deed. [CCP §726(a)]

Thus, the collection of accumulated unpaid late charges is limited to a demand for reinstatement to rescind a foreclosure (started due to a material breach) or on a final payoff, if a proper periodic accounting has been made of the accumulated late charges.

Late charges and public policy

Carryback sellers and lenders holding notes secured by property other than owner-occupied single family residences (SFRs) tend to assume they can charge late fees of any amount they can get the signor of the note to agree to, since the statutory limitations only apply to loans secured by SFRs, or loans made or arranged by a real estate broker on any type of property. This conclusion is called a *negative presumption* and, as in this situation, it is usually erroneous.

However, legislation imposed on late charges for loans encumbering SFRs and one-to-four unit residential properties tends to establish public policy for amounts which are deemed reasonable. Further, case law has set standards requiring late charges to bear a reasonable relationship to the out-of-pocket cost of the lender's collection efforts and lost use of the delinquent principal and interest payment amount. [Garrett, *supra*]

Chapter 12 — Balloon payment notices

This chapter presents the due date notice, its application to debts secured by one-to-four unit residential real estate, and the enforcement of due dates in trust deed notes.

Carrybacks and loans on one-to-four units

A buyer enters into a purchase agreement to acquire a two unit residential property, a duplex,, contingent on obtaining a 90% loan-to-value (LTV) fixed-rate loan to fund the balance of the price after his 10% down payment. Due to a rise in long-term interest rates, the maximum loan amount the buyer qualifies for is less than 90% of the purchase price.

The buyer wants to acquire the duplex, not cancel the transaction. However, he is unable (or unwilling) to increase his down payment and cannot (or will not) now purchase the property on the terms he has agreed to.

As explained to the seller by the listing agent, the seller now needs to consider responding to the buyer by acting on one of three alternatives available to the seller:

- carry back a note secured by a second trust deed for a portion of the agreed-to sales price, with the consent of the new lender;
- reduce the sales price; or
- cancel the sale for lack of sufficient financing, conventional or carryback.

Knowing prices have not risen recently and sensing they will not likely drop in the next few years, the seller agrees with the buyer to carry a second trust deed note, with monthly payments of interest only and a five-year due date. Thus, the carryback note contains a *final/balloon payment* since the debt does not fully amortize over the five-year term. [See **first tuesday** Form 150 §8]

The buyer's final/balloon payment in five years will be nearly 100 times greater than any of the regularly scheduled monthly payments.

Compute and disclose upfront

The dollar amount of the **final balloon payment** in a carryback transaction must be computed and disclosed to the buyer on two separate occasions, since:

- the balloon payment on the due date exceeds twice the regularly scheduled payments; and
- the property contains one-to-four residential units.

The times for the disclosures of the final/balloon payment dollar amount due on the carryback note are:

- first in a Seller Carryback Disclosure Statement submitted to the buyer and seller as an attachment to the purchase agreement, or for further approval (as a contingency) before the close of escrow [Calif. Civil Code §2963; see Form 300 in Chapter 29]; and

- again in a written due date notice delivered at least 90 days, but not more than 150 days, before the balloon payment is enforced by the carryback seller. [See Form 419 accompanying this chapter]

Additionally, the carryback note prepared by escrow is to include the statutory provision which calls for the balloon payment due date notice. [CC §2966(d); see **first tuesday** Form 418-3 §2.1]

Carryback sellers (or the broker or agent preparing the purchase offer) must compute and disclose in the carryback disclosure statement the dollar amount of the balloon payment on an installment sale of any one-to-four unit residential real estate in a carryback disclosure statement, whether or not the buyer will occupy the property. In contrast, money lenders are only required to make the balloon payment calculation and disclosure on loans secured by one-to-four residential units when the secured property is owner-occupied.

Notes containing a balloon payment

A *balloon payment* is any final payment on a note which is an amount greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the balloon payment. [CC §§2924i(d)(1), 2957(b)]

Balloon payment notes are notes with due date provisions calling for an accelerated final payoff of the principal in a lump sum amount before the note balance has been fully amortized.

Also, a note has a final balloon payment if it contains a call provision giving the carryback seller or money lender the right to demand final payment at any time or after a specified time. [CC §§2924i(d)(2), 2957(c)]

Balloon payment notice and due dates

Not all notes with due dates require a balloon payment notice.

A due date notice provision is required to be included in balloon payment notes with a term exceeding one year if:

- the note is carried back by a seller and secured by a trust deed on one-to-four residential units; or

- the note evidences a money loan secured by a trust deed on an owner-occupied, one-to-four unit residential property.

NOTICE OF BALLOON PAYMENT DUE

NOTE: Calif. Civil Code §2966 requires prior written notice at least 90 but not more than 150 days before any balloon payment is due under a carryback note secured by one-to-four unit residential property.

Calif. Civil Code §2924i requires prior written notice at least 90 but not more than 150 days before any balloon payment is due under a money loan secured by owner-occupied one-to-four unit residential property if the loan term is greater than one year.

DATE:_____________, 20______, at ____, California.

To ____the owner of,

real estate referred to as ____

____,

securing a promissory note dated __________________, in the original face amount of $_______________.

NOTICE:

1. A final/balloon payment on this promissory note is due on _____________, 20______.

2. The approximate amount due (including all principal and interest and any other charges due between the date of this notice and the due date) is $_______________.

3. Payment is to be made to ____
(Name and address)

____

____

4. You have a contract right with the undersigned to refinance this final/balloon payment in accordance with the following terms:

4.1 Origination or modification fee $_______________

4.2 Principal amount $_______________

4.3 Interest rate ______%

4.4 Installment payments payable monthly in the amount of $_______________.

4.5 Due date extended to _____________, 20______.

Date:_____________, 20______

Trust Deed Holder: ____

Signature: ____

Address: ____

____

Phone: ____

Fax:____

Email: ____

A due date notice for a final/balloon payment is not required, unless agreed to by both parties, on transactions including:

- carryback notes secured by nonresidential real estate or residential real estate exceeding four units;
- money loans secured by any type of real estate except owner- occupied, one-to-four residential units;
- open-ended credit secured by any real estate; and
- construction loans for any type of improvements. [CC §2924i(b)(1), (3)]

The purpose for the use of the 90/150-day due date notice in any note is to remind the owner of the property of the final payment, and to give him an opportunity to refinance or pay off the note. It also sends a signal to the owner who is negotiating for an extension of the time for a payoff that the noteholder is not likely to extend the due date.

Delivery and contents of the notice

Carryback sellers and lenders must deliver the notice to the buyer or the current owner of the property personally, or by first- class certified mail to the property owner's last known address. The notice must be given at least 90 days, but not more than 150 days, before the due date. [CC §§2924i(c), 2966(a)]

If the notice is not delivered on time, the final due date of the loan is extended until 90 days after proper notice is given. No other terms of the note are affected. Thus, the accrual of interest and the schedule of repayments (and all other terms) on the note remain the same during the extended due date period. [CC §§2924i(e), 2966(b)]

The failure to deliver the notice does not invalidate the note or lessen the property owner's obligation to continue making the regular periodic payments. Non-delivery of the notice merely extends the date by which the property owner is obligated to pay off the note.

If the property owner defaults on a payment during the due-date extension period, the noteholder may initiate foreclosure.

Consequences of non-delivery

A carryback seller secured by a one-to-four unit residential property cannot foreclose if the buyer fails to make a balloon payment on a scheduled due date unless timely written notice of the upcoming payoff date and the amount due was given. [CC §§2924i(e), 2966(b)]

Further, if the carryback seller begins foreclosure proceedings without first giving the due date notice, he is liable to the buyer for any money losses the buyer incurs due to the seller's foreclosure efforts, including attorney fees. [CC §§2924i(f), 2965]

If the carryback seller fails to give proper notice of the balloon payment to the buyer and successfully completes a foreclosure sale and takes title to the property as the high bidder at the trustee's sale, the buyer can rescind the foreclosure sale. However, if an unrelated third party purchases the property at the trustee's sale, the buyer cannot rescind the sale.

When the rescission remedy is not available, money in the amount of the buyer's lost equity can be recovered from the carryback seller. [CC §2966(c)]

Balloon payment disclosures

Sellers who carry back notes containing balloon payments due more than one year after closing and are secured by one-to-four residential units, must initially estimate and disclose the amount of the balloon payment in the Seller Carryback Disclosure Statement. [See Form 300 in Chapter 29]

The disclosure statement, if not prepared and attached to the purchase agreement, must be delivered before escrow closes.

Specifically, the carryback statement requires the buyer to be made aware of:

- the presence of a balloon obligation;
- the approximate amount of the balloon payment;
- any negative amortization; and
- the fact the buyer may not be able to refinance the balloon payment when it is due. [CC §2963]

SECTION C

The Trust Deed

Chapter 13 Trust deed characteristics

This chapter portrays the status of the parties to a trust deed and discusses the nature and purpose of a trust.

A security device and a lien

Financing, in its most basic form, involves a borrower or a buyer who signs and delivers a *promissory note* to the lender or seller as **evidence of the debt** owed for money lent or credit extended.

However, the promissory note itself is only a promise to pay as agreed, not a **guarantee or other assurance** the debt evidenced by the note will be repaid. A **guarantee** is an agreement entered into by a person not obligated under the note to which obligates the person as a *guarantor* pf the borrower's or buyer's performance on the note. In essence, the guarantor has agreed to buy the note on its default. [See Form 439 accompanying this chapter]

In real estate loan transactions, lenders want other assurance the debt owed by the borrower will be repaid. Thus, lenders require borrowers to provide real estate as *collateral* to **secure the performance** of the borrower's promise to pay should he default on the note.

To secure payment of the debt by a parcel of real estate, a *security device* is used in the form of a trust deed agreement. The trust deed is the preferential method used to impose a *lien* on real estate. The **lien** gives the lender or carryback seller both the right and the obligation to foreclose on the real estate on a default in either the note of the security device–the trust deed

The trust deed, by its words, purports to convey legal title to a neutral person, called a *trustee*. In law, the title is not transferred at all. Instead, a **lien** is created to encumber on the owner's title and establish the property as securtity for the debt.

By the use of the trust artifice, title to the property is theoretically held by a trustee as a middleman, **in trust** on behalf of the owner and for the benefit of the lender or carryback seller. Enforcement of the trust provision is permitted by the courts as a legal fiction, unnecessarily employed to invoke the privately contracted for power-of-sale foreclosure provisions which are fully controlled by statute and used in lieu of a judicial foreclosure.

Should the owner ever default on the note or trust deed, the middleman/trustee can be instructed by the lender to sell the property at a public auction to satisfy the debt.

A **trust deed lien** arrangement consists of:

- an identification of the parties and descriptions of the real estate liened as security;
- an identification of the primary money obligation, usually evidenced by a note, which brought about the need for security;
- the terms of the lender's security interest which is the encumbrance on the property, limited to setting out the rights and obligations of the borrower and the lender solely in regard to the real estate; and

GUARANTEE AGREEMENT
For Promissory Note

DATE:_____________, 20______, at ____,California.

Items left blank or unchecked are not applicable.

1. FACTS:

This Guarantee Agreement, called Guarantee, is entered into by

1.1 ____, as the Guarantor,

1.2 and____, as the Creditor,

1.3 regarding a Note in the principal sum of $_______________, dated __________________,

1.4 executed by ____, as the Debtor, in favor of Creditor, and

1.5 secured by a ☐ first, or ☐ second, trust deed and assignment of rents of the same date executed by Debtor as the Trustor, in which Creditor is named as the Beneficiary,

1.6 encumbering real estate referred to as ____
____.

1.7 The Note is accepted by Creditor in reliance on this Guarantee and the financial statements provided by Guarantor.

2. CREDITOR AGREES:

2.1 To notify Guarantor of any foreclosure by Creditor against real estate securing the note as provided in Calif. Civil Code §2924b(c).

2.2 To notify Guarantor of delinquencies in Debtor's payments under the note as provided in Calif Civil Code §2924e(b).

2.3 To apply in any manner and in its sole discretion any payments or recoveries from Debtor or from Guarantor to the indebtedness of Debtor.

2.4 To first credit any recovery by Creditor from any other Guarantor to that portion of the indebtedness of Debtor to Creditor that exceeds the maximum liability under this Guarantee.

3. GENERAL PROVISIONS:

3.1 Any communication or notice under this Guarantee is to be in writing and is effective only if delivered by personal service or mailed by registered or certified mail, postage-prepaid and return receipt requested, except as controlled by sections 2.1 and 2.2 of this agreement.

3.2 This Guarantee is binding on Guarantor, his successor and assigns, and inures to the benefit of Creditor and its successors and assigns.

3.3 No provision of this Guarantee or right of Creditor can be waived, nor can Guarantor be released from his obligations, except in writing signed by Creditor.

3.4 If Guarantor is a corporation, partnership or Limited Liability Company (LLC), each individual executing this Guarantee on behalf of Guarantor represents and warrants he is duly authorized to execute this Guarantee on its behalf.

3.5 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

3.6 This Guarantee will be governed by California law.

4. GUARANTOR AGREES:

4.1 To guarantee to Creditor payment in full, on demand, of all Debtor's monetary obligations, including any future advances and any refund to Debtor by Creditor of any payment received by Creditor on the guaranteed debt, owed under the Note, trust deed and assignment of rents, and any other security agreement, collateral assignments of leases or any other present or future agreement securing performance of the Note.

4.2 To continue liability under this Guarantee, notwithstanding:

a. Any modification of the Note;
b. Any waiver or failure to enforce the Note or related security devices;
c. Any release or modification of any security for the Note, including other guarantees for performance of the Note;
d. Any unenforceability of part or all of the provisions of the Note and related security devices;
e. Any future advances made by Creditor under the Note and trust deed, without notice from Creditor or further authorization from Guarantor; or
f. Any transfer or release of all or a portion of any security for the Note.

4.3 To file all claims against Debtor in bankruptcy or other proceeding on any indebtedness of Debtor to the Guarantor, and to assign to Creditor all Guarantor's rights on any such indebtedness. If Guarantor fails to file any claim, Creditor is authorized to do so in the name of Guarantor or as Guarantor's attorney-in-fact.

4.4 To subordinate any of Guarantor's claims against Debtor to the Note obligations of Debtor to Creditor.

4.5 ☐ The Guarantee is secured by a trust deed. [See **ft** Form 451]

5. GUARANTOR WAIVES:

5.1 All right of subrogation to Creditor's rights against Debtor or to any security for the Note.

5.2 All notices to Guarantor or other persons of the creation, modification, renewal or accrual of any obligations under the Note and security devices, or notice of any other related manner.

5.3 Any failure to timely enforce the Note and trust deed.

5.4 Any statute of limitations.

5.5 Any duty of Creditor to disclose to Guarantor any facts known or discovered about Debtor which materially increase Guarantor's risks of liability.

5.6 Any circumstances which constitute a legal or equitable discharge of Guarantor.

5.7 The right to require Creditor to first proceed against Debtor, to foreclose any lien on any real or personal property to enforce the note, to pursue any remedy or to enforce any right before proceeding on this Guarantee.

5.8 Any Debtor defenses to Creditor's rights to collect on the Note or to Creditor's exercise of any of its rights under the Note, which Debtor defenses shall not constitute a legal or equitable discharge of Guarantor.

6. OTHER: ____
____
____
____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:____________, 20______	Date:____________, 20______
Creditor's Signature: ______________________	Guarantor's Signature: ______________________
Creditor's Signature: ______________________	Guarantor's Signature: ______________________
Address: ______________________________	Address: ______________________________
______________________________	______________________________
Phone: ______________________________	Phone: ______________________________
Fax: ______________________________	Fax: ______________________________
Email:______________________________	Email:______________________________

- the borrower's signature and notary acknowledgments. [See Form 450 in Chapter 14]

Parties to the trust deed

The trust deed identifies three parties, each of whom has distinctly separate roles in the secured transaction:

1. The owner, called the *trustor*, who voluntarily imposes the trust deed lien on his property.

2. The middlemen, called the *trustee*, who holds the power of sale over the property.

3. The lender or carryback seller, called the *beneficiary*, who benefits from the trust deed lien encumbering the property.

The trustor as the owner

The trustor who signs and delivers a trust deed to a lender or carryback seller must be the **owner** of the real estate interest encumbered when the trust deed is delivered. Delivery is usually accomplished by recording the trust deed with the county recorder, which also *perfects* its priority on title.

The owner creating a trust deed encumbrance on real estate usually is the borrower of money or buyer of the property in a credit sale. However, an owner can impose a trust deed lien on the title to his property to provide security for the performance of any lawful act he may have agreed to, or as security for another person's debt, including other individuals, a corporation, limited liability company (LLC) or partnership debt. [**Everly Enterprises, Inc.** v. **Altman** (1960) 54 C2d 761]

The owner's real estate interest which is encumbered can be less than the entire fee, such as a fractional co-ownership, leasehold interest or life estate in the property.

For example, a condominium owner, or any other property owner, can encumber his long-term leasehold interest under which he holds possession, even though some other person is the fee owner of the real estate. [Calif. Civil Code §§783, 1091, 2947]

Other real estate interests which can be encumbered besides the fee, leasehold, and life estates include beneficial interests of creditors in existing trust deeds, equitable ownership rights under land sales contracts, and purchase rights under options to buy.

As mentioned, the owner does not need to be the sole owner of an interest in the property to encumber his interest with a trust deed. For example, one tenant-in-common or joint tenant (except a husband or wife) can, unless agreed to the contrary with other co-owners, sell or encumber his individual ownership interest without the consent of his co-owner or co-owners. [**Thompson** v. **Thompson** (1963) 218 CA2d 804]

However, the trust deed lien created by the owner of a fractional interest in the real estate attaches only to the owner's interest in the property, not to the interests of his co-owners. [**Caito** v. **United California Bank** (1978) 20 C3d 694]

If community property is to be encumbered, both spouses must consent to the encumbrance of the community real estate interest, with the exception of attorney fees agreements in divorce proceedings. [Calif. Family Code §1102]

An off-record spouse who does not consent to an encumbrance can have a lien removed from the community property. To do so, the action must be filed within one year of the date the trust deed is recorded.

The trustee's authority

Despite the wording in the trust deed stating the trustor "hereby grants and conveys to trustee...the following real property...", the trustee receives no ownership or security interest in the real estate, and holds no legal right to any interest in the property. The trustee merely receives the **authority** to carry out the activities vested in the trustee by the power-of-sale provision in the trust deed lien held by the beneficiary. [**Lupertino** v. **Carbahal** (1973) 35 CA3d 742]

Under the trust deed, the trustee's only responsibilities concerning the property are:

- **to auction the property** at a public sale on notice from the lender of a default and election to sell; and
- **to reconvey title** to the owner and release the lender's lien on instructions from the beneficiary or the trustor.

The owner's *possessory right* (fee, leasehold, or life estate) to the property is not transferred to the trustee under a trust deed. The trustor, as the owner of the real estate, remains free to occupy, sell, lease or further encumber his property, subject to existing liens.

Any person other than the owner of the real estate may serve as trustee. This includes the beneficiary of the trust deed, be he lender or carryback seller. [**More** v. **Calkins** (1892) 95 C 435]

Some private lenders name their attorney or broker as the trustee. Most often, however, title and escrow companies unknowingly play the role of trustee in a particular transaction by virtue of the lender's use of regular trust deed forms the title companies distribute throughout the financial and brokerage industries.

The key difference between the trust deed's legal fiction as a trust and a genuine trust is that the trustee under a trust deed is designated without his knowledge or consent. A true trustee must consent to his appointment. [Calif. Probate Code §15600]

Under a trust deed lien, the trustee is treated as **non-existent** until the lender elects to foreclose by a trustee's sale or is required to reconvey (release) the beneficiary's security interest in the property.

The position held by the trustee in a trust deed functions merely as the passive repository of an auctioneer's power to conduct a private sale as agreed to in the trust deed. The trustee's conduct is in nearly all aspects completely controlled by statutes. [**Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268; CC §2924 et seq.]

When the trustee is called on by the beneficiary to actually carry out its responsibilities under the power-of-sale provision, it is required to act impartially.

Thus, a trust deed lien does not create a trust relationship between the parties to the trust deed, even though words of trust and conveyancing are used.

Even though the trustee's instructions to sell or reconvey come primarily from the beneficiary, the trustee is regarded as a *common agent* and bears a responsibility to both the beneficiary and the trustor to absolutely follow the strict statutory foreclosure scheme. [**Kerivan** v. **Title Insurance and Trust Company** (1983) 147 CA3d 225]

The beneficiary is the lienholder

The **beneficiary**, such as a lender or carryback seller, is the person entitled to the performance of the promised activity referenced in the trust deed as the purpose for obtaining the security, usually the repayment of a debt evidenced by a note.

The beneficiary, like the trustee, receives no ownership interest in the property. But unlike the trustee, the beneficiary **holds an interest** in the property, a security interest called a *lien*.

Thus, the beneficiary has the power to instruct the trustee (who could be himself) to sell the secured property on behalf of the beneficiary (himself). In turn, the trustee has authority from both the trustor and the beneficiary under the power-of-sale provision in the trust deed to sell the property in conformance with the statutory scheme on a declaration from the trust deed beneficiary. [Prob C §§16000, 16420(a)(1)]

A trust deed acts only as a lien

The modern California trust deed gives the beneficiary a lien as a security interest in the real estate. The trust deed authorizes the sale of the property by a trustee's sale under the power-of-sale provision to enforce collection of the secured debt. With the exception of the power-of-sale provision, the trust deed is identical to its predecessor, the mortgage. [**Bank of Italy Nat. Trust & Savings Ass'n** v. **Bentley** (1933) 217 C 644]

For example, a lender is a beneficiary under a trust deed on property which secures a construction loan made to the owner of the property. The owner defaults on loan payments and the lender instructs the trustee under the trust deed to notice the default and proceed with a foreclosure sale, called a *trustee's sale*.

Before the trustee's sale is held, a contractor seeking to foreclose on a mechanic's lien sues and records a lis pendens, claiming an interest in title to the property. However, the mechanic's lien foreclosure action references only the trustee's interest in the real estate as the interest claimed by the contractor to satisfy his money demands.

At the trustee's sale, the lender acquires title to the property. Later, the contractor, under his mechanic's lien foreclosure action, obtains a judgment and is awarded the trustee's interest in the property. The contractor, to enforce collection of money under his judgment through a sheriff's sale, completes his judicial foreclosure and becomes the owner of the trustee's interest in the secured property. The contractor does not pursue any lien rights against the lender's interest in the property as the new owner under the trustee's deed.

Does the contractor's enforcement of his judgment against the trustee's interest under the trust deed give him any interest in the property?

No! A trustee under a trust deed has no interest in the property and thus holds nothing of value to be attached. The contractor failed to pursue the lender, who was the only person (other than the owner) with an interest in the property, both before and after the trustee's sale. The contractor's judgment against the trustee only attached to the trustee's interest under the trust deed — an interest limited to the power to sell the property at an auction for the benefit of the lender, which it did. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454]

Under a trust deed, title to the property appears to be held by a trustee. But the deed conveying title into the purported "trust" is a legal fiction. The sole purpose for recording a trust deed is to **perfect** the lender's security interest in the property. The trust deed conveyance only imposes a lien on the real estate and carries with it none of the possessory rights of ownership to the collateral.

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street
Address

City &
State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

SUBSTITUTION OF TRUSTEE AND RECONVEYANCE

DATE: ______________, 20______, at ____, California.

____, as the present Beneficiary,

under a Deed of Trust dated __________________________, recorded on __________________________________,

as Instrument No. __________________, in the Official Records of _________________________County, California,

executed by ____, as the Trustor,

HEREBY APPOINTS____, as the Trustee under the Deed of Trust.

Trustee, on written request from the present Beneficiary of the Deed of Trust, HEREBY RECONVEYS and releases, to the persons legally entitled thereto, the interest held by Trustee under the Deed of Trust.

____
(Signature of Beneficiary)

____
(Signature of Successor Trustee)

STATE OF CALIFORNIA
COUNTY OF____
On ____ before me,
____
(Name and title of officer)
personally appeared ____
____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature____
(Signature of notary public)

(This area for official notarial seal)

FORM 472 04-08

Extinguishing the relationship

The trust deed ceases to exist when its purpose as security for a debt ends.

Thus, once the beneficiary has received the full amount of money he is entitled to receive under the note and trust deed, any later claim of the beneficiary to a security interest in the property or activity of the trustee (except reconveyance) is invalid.

Removing the trust deed from the title to the property on ending the debt relationship between the owner and the creditor is accomplished in one of three ways:

- **foreclosure** by issuance of a trustee's deed or sheriff's deed [See Form 475 in Chapter 47];
- **full repayment** by reconveyance [See Form 472 accompanying this chapter]; or
- **mutual agreement** by a deed-in-lieu of foreclosure. [See Form 406 in Chapter 50]

Foreclosure of the trust deed lien is accomplished by a public auction at a trustee's sale or sheriff's sale, the proceeds of which are applied to the debt.

Even if the price bid at the foreclosure sale is insufficient to fully satisfy the note, the foreclosure sale terminates the trust deed lien on the property sold by canceling the trust deed's effect on the title on issuance of the trustee's or sheriff's deed.

Full repayment of the debt requires the beneficiary to cause the trust deed to be reconveyed. Once the debt is fully repaid, the beneficiary delivers the original note to the trustee, together with a request for a reconveyance of title. In turn, the trustee records a reconveyance of the trust deed. [See Form 472]

A trustee who erroneously reconveys when the owner is not entitled to a release of the lender's lien on the property is liable for the beneficiary's resulting money losses.

However, the beneficiary's monetary recovery from the trustee is limited to the market value of the secured property. [**Jeanese, Inc.** v. **Surety Title & Guaranty Co.** (1959) 176 CA2d 449]

On a request for reconveyance, the trustee will demand identification of the beneficiary and require the original note be marked paid. After recording the reconveyance, the trustee will deliver the note to the owner at the owner's request.

Unless the recorded trust deed lien expires earlier, the lien expires and is no longer enforceable by any means after the later of:

- ten years after the final maturity date contained in the recorded trust deed; or
- 60 years after the recording of the trust deed if the final maturity date cannot be ascertained from the recorded trust deed. [CC §882.020]

Failure to reconvey on payoff

Failure of the beneficiary or trustee to comply with mandatory reconveyance requirements results in liability for the owner's actual money losses, a penalty of $300 and criminal liability punishable by a fine of $400 and six months imprisonment. [CC §§2941, 2941.5]

Copies of lost or destroyed originals will be accepted from the beneficiary by the trustee for purposes of reconveyance if they are accompanied by:

- the beneficiary's sworn statement;
- an agreement to indemnify; and
- a lost instruments bond. [**Huckell** v. **Matranga** (1979) 99 CA3d 471]

As an alternative, the beneficiary may avoid unnecessary fees and bonds by substituting trustees — such as himself — to act as the trustee and reconvey the trust deed lien.

When the beneficiary refuses to reconvey on full satisfaction of the debt or cannot be located, the owner, as trustor, can obtain and record a corporate bond in the county where the encumbered property is located. The corporate bond is to be issued in a sum the greater of either:

- two times the amount of the original obligation, plus advances; or
- half of the compounded obligation plus interest. [CC §2941.7(a)]

The corporate bond must be accompanied by a declaration containing the name of the trustor and beneficiary, as well as the name and address of the individual making the declaration, generally the trustor. The declaration must state either:

- the obligation has been fully satisfied but the beneficiary cannot be located or refuses to reconvey; or
- a balance exists, including principal and interest, but the beneficiary cannot be located. [CC §2941.7(b)(4)]

The trustor must send a notice by certified mail to the trustee and the last beneficiary of record stating the trustor has recorded the bond and declaration. The notice must state the trustee may record a written objection to the release of the obligation. [CC §2941.7(b)(5)]

Also, the creditor and property owner may **mutually agree** to terminate the security interest evidenced by the trust deed lien with:

- a deed-in-lieu of foreclosure and reconveyance of the trust deed; or
- a substitution of security and reconveyance of the trust deed without first paying the debt in full.

Under a deed-in-lieu of foreclosure, the owner conveys his entire interest in the property to the beneficiary in exchange for the beneficiary canceling any remaining debt and reconveying the trust deed. Thus, the trustor/beneficiary relationship between the owner and the creditor under the trust deed is terminated. [See Chapter 50]

Chapter 14 — The long form trust deed

This chapter introduces and explains a modern trust deed used in California by carryback sellers and private lenders operating outside the national secondary mortgage market.

Reflecting the limits of enforcement

Through the provisions of a trust deed, a private lender or carryback seller, also called a *secured creditor*, tries contractually to restrict or to regulate as many aspects of **ownership and possession** of the liened property as they are legally able to control.

At first glance, the list of rights given to the private lender or carryback seller seems to authorize their use of tremendous **discretionary powers** over activity normally conducted by owners of real estate.

For example, trust deeds routinely purport to give the secured creditor the unhindered ability to:

- automatically accelerate the balance of the loan on the transfer of any interest in the property, such as an owner's sale, further encumbrance or lease of the property;
- determine the allocation of condemnation (eminent domain) proceeds;
- apply all fire insurance proceeds to the secured debt; and
- call the loan if it or any other loan between the parties is in default, called a *dragnet clause*.

Fortunately for owners of property they have encumbered with a trust deed lien, California law curbs the secured creditor's ability to strictly enforce **discretionary provisions**, as well as many other clauses which appear in some trust deeds.

First, trust deeds are recognized as *adhesion contracts*, offered by a person with superior bargaining power (the secured creditor) to a weaker person (the borrower) on a "take it or leave it" basis.

A prospective borrower typically has no power to negotiate better terms than those provided in regular trust deeds. The printed terms must be adhered to when borrowing money.

This imbalance in bargaining power led California courts to develop special adhesion contract rules for interpreting rights and obligations under trust deeds. [**Steven** v. **Fidelity and Casualty Company of New York** (1962) 58 C2d 862]

One rule of the adhesion theory requires a trust deed to be interpreted in light of the reasonable expectations of the weaker party, the borrower. [**Yeng Sue Chow** v. **Levi Strauss & Co.** (1975) 49 CA3d 315]

Second, as the discussion of each individual trust deed provision shows, many of the rights claimed by the secured creditor are restricted, if not completely unenforceable for lack of any basis for protecting the lender against the risk of loss on their loan.

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

LONG FORM TRUST DEED AND ASSIGNMENT OF RENTS

Securing a Promissory Note

This Deed of Trust, made this ____________________ day of ________________________________, 20______, between ____, as the Trustor, whose address is ____,
(Number and street) (City) (State) (Zip)
____, a California corporation, as the Trustee, and ____, as the Beneficiary.

1. Trustor hereby **IRREVOCABLY GRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE,**

1.1 The real property in the City of ____,
County of ____, California, referred to as:

1.2 TOGETHER WITH the rents, issues and profits of the real property, subject to the provisions of §3.4, herein to collect and apply the rents, issues and profits,

1.3 **For the purpose of securing payment of:**

a. the indebtedness evidenced by a promissory note of same date executed by Trustor, in the sum of $_____________;
b. any additional sums and interest hereafter loaned by Beneficiary to the then record Owner of the real property, evidenced by a promissory note or notes, referencing this Deed of Trust as security for payment;
c. the Beneficiary's charge for a statement regarding the secured obligations requested by or for Trustor; and
d. the performance of each agreement contained in this Deed of Trust.

2. To protect the security of this Deed of Trust, Trustor agrees:

2.1 **CONDITION OF PROPERTY** — To keep the property in good condition and repair; not to remove or demolish any building; to complete and restore any building which may be constructed, damaged or destroyed; to comply with all laws affecting the property or requiring any alterations or improvements to be made; not to commit or permit waste; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of the property may be reasonably necessary.

2.2 **HAZARD INSURANCE** — Trustor will continuously maintain hazard insurance against loss by fire, hazards included within the term "extended coverage," and any other hazards for which Beneficiary requires insurance. The insurance shall be maintained in the amounts and for the periods Beneficiary requires. The insurance carrier providing the insurance shall be chosen by Trustor, subject to Beneficiary's approval, which shall not be unreasonably withheld. All insurance policies shall be acceptable to Beneficiary, and contain loss payable clauses in form acceptable to Beneficiary. Beneficiary shall have the right to hold policies and renewals.

In the event of loss, Trustor shall give prompt notice to the insurance carrier and Beneficiary. Beneficiary may make proof of loss if not made promptly by Trustor. Beneficiary may place the proceeds in a non-interest bearing account to be used for the cost of reconstruction of the damaged improvements. If Trustor fails to reconstruct, Beneficiary may receive and apply the loan proceeds to the principal debt hereby secured, without a showing of impairment.

2.3 **ATTORNEY FEES** — To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Beneficiary or Trustee; and to pay all costs and expenses, including cost of evidencing title and attorney fees in a reasonable sum, in any such action or proceeding in which Beneficiary or Trustee may appear.

2.4 **TAXES AND SENIOR ENCUMBRANCES** — To pay at least 10 days before delinquency: all taxes and assessments affecting the property, including water stock assessments when due, all encumbrances, charges and liens, with interest, on the property which are or appear to be senior to this Deed of Trust; and all expenses of this Deed of Trust.

2.5 **ACTS AND ADVANCES TO PROTECT THE SECURITY** — If Trustor fails to make any payment or to perform any act provided for in this Deed of Trust, then Beneficiary or Trustee may, without obligation to do so, and with or without notice or demand upon Trustor, and without releasing Trustor from any obligation under this Deed of Trust:

a. make or do the same to the extent either deems necessary to protect the security, Beneficiary or Trustee being authorized to enter upon the property to do so;

b. appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Beneficiary or Trustee;

c. pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this Deed of Trust.

In exercising the power of this provision, Beneficiary or Trustee may incur necessary expenses, including reasonable attorney fees.

Trustor to immediately pay all sums expended by Beneficiary or Trustee provided for in this Deed of Trust, with interest from date of expenditure at the same rate as the principal debt hereby secured.

3. It is further mutually agreed that:

3.1 **ASSIGNMENT OF DAMAGES** — Any award of damages made in connection with:

a. condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or

b. injury to the property by any third party;

is assigned to Beneficiary, who may apply or release the proceeds of such award in the same manner and with the same effect as above provided for the disposition of hazard insurance proceeds.

3.2 **WAIVER** — By accepting payment of any sum due after its due date, Beneficiary does not waive Beneficiary's right to either require prompt payment when due of all other sums or to declare a default for failure to pay. Beneficiary may waive a default of any agreement of this Deed of Trust, by consent or acquiescence, without waiving any prior or subsequent default.

3.3 **DUE-ON-SALE** — Should Trustor sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, then Beneficiary may, at Beneficiary's option, declare all sums secured by this Deed of Trust immediately due and payable.

3.4 **ASSIGNMENT OF RENTS** — Trustor hereby assigns and transfers to Beneficiary all right, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this Deed of Trust.

a. Prior to a default on this Deed of Trust by Trustor, Trustor shall collect and retain the rents.

b. On default by Trustor, Beneficiary shall immediately be entitled to possession of all unpaid rents.

3.5 **ACCELERATION** — If payment of any indebtedness or performance of any agreement secured by this Deed of Trust is in default, Beneficiary may at Beneficiary's option, with or without notice to Trustor, declare all sums secured immediately due and payable by:

a. commencing suit for their recovery or for foreclosure of this Deed of Trust; or

b. delivering to Trustee a written notice declaring a default with demand for sale; a written Notice of Default and election to sell to be recorded by Trustee.

3.6 **TRUSTEE'S SALE** — On default of any obligation secured by this Deed of Trust and acceleration of all sums due, Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with Calif. Civil Code §2924 et seq.

3.7 **TRUSTOR'S OFFSET STATEMENT** — Within 10 days of Trustor's receipt of a written request by Beneficiary, Trustor shall execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of Beneficiary: the then owner of the secured property; the terms of the secured note, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured note is valid and the Trustor received full and valid consideration for it; and that Trustor understands the note and this Deed of Trust are being assigned.

4. ADDENDA — If any of the following addenda are executed by Trustor and recorded together with this Deed of Trust, the covenants and agreements of each shall incorporate, amend and supplement the agreements of this Deed of Trust (check applicable boxes):

☐ Owner-occupancy rider; ☐ All-inclusive trust deed addendum; ☐ ___________________________;
☐ Impounds for taxes and insurance addendum; ☐ Private Mortgage Insurance (PMI) rider.

5. RECONVEYANCE — Upon written request from Beneficiary stating that all sums secured by this Deed of Trust have been paid, surrender of this Deed of Trust and the note to Trustee for cancellation, and payment of Trustee's fees, Trustee shall reconvey the property held under this Deed of Trust.

6. SUCCESSORS, ASSIGNS AND PLEDGEES — This Deed of Trust applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Beneficiary shall mean the holder and owner of the secured note, or, if the note has been pledged, the pledgee.

7. TRUSTEE'S FORECLOSURE NOTICES — The undersigned Trustor requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Trustor at the address herein set forth.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: ____________, 20_____ Trustor: ____

Date: ____________, 20_____ Trustor: ____

STATE OF CALIFORNIA
COUNTY OF___________________________________
On ____________________________________ before me,
____
(Name and title of officer)
personally appeared ______________________________
____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ______________________________________
(Signature of notary public)

(This area for official notarial seal)

The purported rights of the secured creditor, agreed to by the buyer or owner when executing the trust deed, are controlled by statutes, case law interpretations regarding fairness and good faith, and ancient common law doctrines governing the conduct of persons holding interests in real estate.

As a result of California's specific *mortgage law*, the mere inclusion of an otherwise valid and enforceable *contract clause* in a trust deed restricts the use of its provisions by setting parameters for the trust deed lender's enforcement of its powers.

Provisions of a trust deed

The following is an analysis of the necessary and enforceable provisions in a regular trust deed used to secure the performance of a note. Section references are to **first tuesday's** Form 450 — Long Form Deed of Trust and Assignment of Rents, accompanying this chapter.

2.1 — Condition of property

A **condition of property provision**, also called a **nonwaste provision**, obligates the owner to maintain the property in good physical condition. It covers two events.

First, the provision is, in its purpose for protection, a redundant recital. An owner of secured property is barred by statute from impairing the creditor's security interest in the property, called *waste*. [Calif. Civil Code §2929]

Secondly, inclusion of the nonwaste provision is necessary to give the secured creditor the **right to call** the secured loan on a breach of the owner's obligation to maintain the secured property in an unimpaired condition. If the loan is not paid in full on the call, the creditor may commence foreclosure. Without the provision, the creditor is limited to a court action for money damages, injunction and receivership of the property under the waste statute.

Conversely, a nonwaste provision in the trust deed is unenforceable if it is unrelated to protecting the value of the creditor's security from impairment. The owner of the secured real estate has the right to use the property as he wishes and is limited only by general land-use laws.

An owner's promise to maintain the property only bars him from activities and use of the property which jeopardizes the loan-to-value ratio of the creditor's security interest in the property. [**Krone** v. **Goff** (1975) 53 CA3d 191]

For example, many trust deeds contain a clause in which the owner promises "not to commit, suffer or permit any act *upon said property* in violation of law". Such a **violation of law provision** is unenforceable, since it address activities unrelated to the maintenance or value of the secured property. However, provisions promising to comply with laws **affecting** the property's value are enforceable, and are properly included in the nonwaste provision.

2.2 — Hazard insurance

Under the **hazard insurance provision**, the secured creditor has the right to **call the loan** when the owner fails to provide hazard insurance which is acceptable to the creditor.

Should the owner then fail to satisfy the loan after the call or to provide the insurance coverage to reinstate the trust deed, the secured creditor can:

- begin foreclosure immediately, subject to the owner's right to reinstate by providing acceptable insurance; or

- acquire acceptable insurance, pay the premium and either add the amount to the debt under the future advances clause in the trust deed and continue to accept payments on the note, or make a demand for reimbursement, and if not paid in full, call the loan and commence foreclosure.

The secured creditor can require the owner to carry hazard insurance up to the **replacement cost** of any improvements, even if the costs exceed the loan amount or the property's fair market value. [CC §2955.5]

However, the secured creditor must allow the owner to rebuild damaged improvements, unless the rebuilding effort would impair the creditor's security. [**Schoolcraft** v. **Ross** (1978) 81 CA3d 75; see Chapter 15]

2.3 — Attorney fees

Attorney fees and costs incurred in litigation to protect, not foreclose, the secured creditor's security interest in the property are recoverable under the **attorney fees provision** to the extent the fees are reasonable. [**Buck** v. **Barb** (1983) 147 CA3d 920]

Trust deeds give the secured creditor remedies to **protect his security interest** in the real estate. *Remedial actions* are unrelated to the collection of the debt evidenced by the note or other document which are secured by the trust deed. Thus, an attorney fees provision is needed in the trust deed, even though the note contains an attorney fees provision. [**Hellier** v. **Russell** (1902) 136 C 143]

Attorney fees paid by the secured creditor for professional services needed to enforce the trust deed are considered future advances, and are thus also secured by the trust deed.

If the secured creditor records a Notice of Default (NOD), all amounts advanced (including reasonable attorney fees incurred to enforce provisions to protect the status of the trust deed) must be paid to reinstate the trust deed. [**Bisno** v. **Sax** (1959) 175 CA2d 714; CC §2924c]

Conversely, recovery of attorney fees or trustee's fees incurred to judicially or nonjudicially foreclose on the property under the trust deed lien are capped by statute. [See Chapter 51]

2.4 — Taxes and senior encumbrances

The **tax and senior encumbrance provisions** obligate the owner to keep all taxes and senior liens current. If the owner fails to do so, the beneficiary may call the loan due and either:

- foreclose if not reimbursed; or

- pay the taxes under the future advances clause and add that amount to the loan balance. [CC §2876]

Should a senior lender commence foreclosure and the loan not be reinstated or paid in full, the senior lender's foreclosure sale will wipe out any junior creditor's security interest in the property as a lienholder.

Similarly, property tax liens annually attach to the property and are senior to all trust deed holders. A tax lien which is delinquent may be foreclosed after five years. Any property tax sale will eliminate a creditor's secured position in the title. [Calif. Revenue and Taxation Code §2192.1]

2.5 — Acts and advances to protect the security

The **future advances provision** obligates the owner to reimburse the secured creditor on demand for any amounts advanced by the creditor under any provision of the trust deed — e.g., to pay insurance premiums, defend the security, or bring taxes and senior liens current.

All advances made by the secured creditor become part of the debt secured by the trust deed. If the owner fails to reimburse the secured creditor, the creditor may call due (accelerate) all amounts secured by the trust deed and foreclose on the property if the call is not fully paid, unless the debt is brought current as permitted by reinstatement rules. [**Windt** v. **Covert** (1907) 152 C 350]

3.1 — Assignment of damages

Condemnation:

Government agencies sometimes condemn part or all of a secured property in an *eminent domain action*, or damage the value of the property by their actions. Here, the agency must compensate the secured creditor for the loss of his security, which occurs on the date of the **taking**, and for any loss of money (damages) additionally suffered by the owner. [Calif. Code of Civil Procedure §1260.220]

Accordingly, any condemnation award obtained by the owner of the secured property is subject to the lien created by the trust deed. Equity (fairness) law requires the money award to stand as *substitute security* for the property it replaces on the taking. [**American Savings and Loan Association** v. **Leeds** (1968) 68 C2d 611]

However, the assignment of condemnation proceeds to the secured creditor under the **condemnation provision** in the trust deed is not the absolute assignment it appears to be. The creditor is not allowed to apply the entire amount of the condemnation proceeds to the satisfaction of the secured debt if any portion of the secured real estate remains after the taking.

Rather, the assignment provision is merely a *collateral assignment* of the funds for the purpose of securing the debt. Thus, the secured creditor may keep only that portion of the condemnation proceeds necessary to **prevent impairment** of his security, called exercising control in *good faith*. The remaining funds must be released to the owner. [**Milstein** v. **Security Pacific National Bank** (1972) 27 CA3d 482]

With a partial taking, the secured creditor shares the award only to the extent necessary to protect and maintain the level of his security interest. If the partial taking does not create an impairment (reduces the property's value), the creditor is not entitled to any of the proceeds. [CCP §1265.225]

Impairment may occur even though the value of the property after a partial taking exceeds the balance outstanding on the debt. When the debt-to-equity or *loan-to-value ratio* (LTV) existing before the taking is altered substantially due to a reduction in value by the partial taking, the secured creditor is entitled to a portion of the funds needed to bring his debt-to-equity ratio back in line with the pre-taking ratio.

Any dispute regarding the extent of the secured creditor's impairment will be resolved by comparing the debt-to-equity (LTV) ratios before and after the taking. Other risk factors influencing the impairment include the owner's payment history, the economic effect of the taking on the remainder of the property, and whether the creditor has recourse on the obligation. [**People** v. **Redwood Baseline Ltd.** (1978) 84 CA3d 662]

Injury to the property by third-parties:

Coupled with the trust deed provision which collaterally assigns condemnation proceeds to the secured creditor is a **third-party injury clause**. It provides the creditor with an assignment of any award received by the owner for injuries to the property inflicted by private, non-governmental third parties.

Thus, the secured creditor may recover awards received by the owner for damages to the property, subject to the same standards of good faith which apply to the provisions assigning condemnation awards and insurance proceeds. [**Duarte** v. **Lake Gregory Land and Water Co.** (1974) 39 CA3d 101]

However, only money judgments compensating the owner for **actual injury** to the physical property which reduces its value may be participated in by the secured creditor.

3.2 — Waiver

The **nonwaiver provision** establishes the secured creditor's right to accept partial payments of amounts due under the note and trust deed without waiving the right to commence or continue foreclosure based on the owner's default in payments. [**M.E. Hersch** v. **Citizens Savings and Loan Association** (1983) 146 CA3d 1002; see Chapter 49]

The second part of the nonwaiver provision is a **general waiver** which allows the secured creditor to forego enforcement of the trust deed provisions on a default without waiving his right to commence foreclosure on a later default.

For example, the secured creditor's consent to a transfer of the real estate under the trust deed's due-on clause does not waive the right of the lender to interfere with further transfers, unless the creditor agrees in writing to waive his right to call or recast the debt on future transfers.

3.3 — Due-on-sale

A secured creditor may enforce his **due-on clause**, also called an *alienation clause*, by automatically calling the debt due on a voluntary or involuntary transfer of any legal or equitable interest in the property. [12 Code of Federal Regulations §591.2; see Chapter 16]

3.4 — Assignment of rents

Two types of **assignment of rents provisions** exist:

- an absolute assignment; and
- a conditional assignment.

However, the distinction between the two types of assignment of rents clauses is not of concern to the holder of a trust deed recorded after 1996.

Editor's note — For assignment of rents clauses recorded before 1997, the rules regarding the distinctions between the two types of rent clauses still govern their perfection and enforcement. [See Chapter 38]

A trust deed signed and delivered (recorded) after 1996, containing either type of assignment of rents clause, creates a *present security interest* in existing and future leases, rents, issues or profits on the secured real estate. This security interest is properly referred to as a *lien*. [CC §2938(a)]

The assignment of rents clause may be in a separate lien agreement, but is usually placed in the trust deed recorded against the real estate involved.

Once the assignment (trust deed containing the provision) is recorded, it:

- gives *constructive notice* to all persons of the lender's security interest in the rents; and
- is *fully perfected* even though the provision states the assignment is unenforceable until a default occurs on the note or trust deed. [CC §2938(b)]

Perfection by recording establishes that the lender's security interest in the rents has priority over security interests in the rents later acquired by other creditors or owners of the property.

3.5 — Acceleration

The trust deed debt **acceleration provision** allows the secured creditor to call the full amount of all sums secured by the trust deed due and payable on **any default** under the provisions of the trust deed.

Although not necessary, notes secured by trust deeds also contain acceleration clauses. However, trust deed provisions relate to the property and are not properly contained or referenced in the note secured by the trust deed.

Thus, an acceleration provision in the trust deed allows the secured creditor to accelerate payment of all secured obligations (not just the debt evidenced by the note) when the owner breaches any provision of the trust deed, which includes a default on the note.

Also, the acceleration provision in the trust deed gives notice to future owners and encumbrancers of the property that the secured obligation can be accelerated on any default. [Calif. Financial Code §1227.2]

Of course, any acceleration is subject to reinstatement rights, except for calls under the due-on clause, waste provisions and violations of law affecting the value of the real estate since they are incurable breaches requiring redemption of the property by payment in full. [See Chapter 45]

3.6 — Trustee's sale

The **power of sale provision** grants to a named or an unnamed trustee, coupled with an agreement between the owner and the secured creditor to hold a sale of the property on the owner's default, the authority to sell the property by a private trustees' sale if the owner defaults. [CC §2924 et seq.; see Chapter 47]

The completion of a trustee's foreclosure sale extinguishes the owner's ownership interest in the property and terminates his right to redeem the property by paying off the debt. [CC §2903]

3.7 — Trustor's offset statement

If the secured creditor later sells or collaterally assigns the trust deed note to a trust deed investor, the **offset statement provision** requires the owner to cooperate by completing and delivering a trustor's offset statement for use by the trust deed investor. [See **first tuesday** Form 428]

The trust deed investor buying or lending on the note will require the statement to confirm whether the note is valid.

The statement is requested by the secured creditor through the trust deed sales escrow, and delivered to the trust deed investor.

The trustor's offset statement confirms the terms of the note and the existence of any claims or offsets held by the owner against the note or the trust deed holder assigning the note. The offset information is necessary to establish the assignee's status as a holder in due course on his acquisition of a trust deed note.

The owner of the secured real estate has no duty to respond to the request for an offset statement, unless agreed to in the note or trust deed.

4 — Addenda

Special use agreements not covered by standard boilerplate provisions in the trust deed are attached as addenda to the trust deed, sometimes called *riders*.

Examples include:

- the all-inclusive trust deed (AITD) addendum [See Forms 442 and 443 in Chapter 34];
- agreements for impound accounts [See Form 455 in Chapter 16];
- owner-occupancy riders; and
- agreements for mortgage indemnity insurance.

5 — Reconveyance

Within 30 days after payoff of the secured obligation, the secured creditor must deliver instructions to the trustee to record a **deed of reconveyance** or reconvey the trust deed himself. Both the note and the trust deed are returned to the property owner when the debt is fully satisfied. [CC §2941; see **first tuesday** Form 472]

Failure by the secured creditor or trustee to reconvey is a misdemeanor, punishable by a fine of up to $400 and up to six months in jail, or both. Also, the secured creditor or trustee who fails to reconvey is liable for any losses sustained by the owner as a result, plus a civil penalty of $500. [CC §§2941.5, 2941(d)]

6 — Successors, assigns and pledgees

A **successor and assignee provision** extends the rights and obligations under the trust deed to all successors-in-interest of the owner of the secured real estate or the secured creditor.

Even without a successor provision, the owner's successor takes title to the secured property subject to the secured creditor's trust deed, regardless of whether he has in any manner assumed the owner's obligations on the secured note. Thus, the successor must maintain the terms of the note, even though he is not a party to it, to prevent losing the property to foreclosure, called *privity of estate*. [**Rodgers** v. **Peckham** (1898) 120 C 238]

Further, the owner can enforce provisions in the trust deed against the creditor even though he did not assume the obligations of the note and trust deed since a subject-to buyer's ownership of the property is the interest which secures the creditor's recovery on the note. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

7 — Trustee's foreclosure notices

A county recorder can only record those trust deeds which contain an owner's request for a notice of default (NOD). [Calif. Government Code §27321.5; see Form 471 in Chapter 47]

The trustee commencing foreclosure proceedings must mail a copy of the NOD by certified or registered mail, and a second copy by first-class mail, to the owner's last known address. [CC §2924b(b)]

If the owner fails to specify his address in the trust deed or changes his address, he may later request the NOD be mailed to him at a new address by recording a statutory **Request for NOD** form. [CC §2924b(a); see Form 412 in Chapter 48]

If there is no address for the owner in the trust deed or Request for NOD form, the trustee must:

- **Publish** a copy of the NOD in a newspaper of general circulation in the county where the property is located, once a week for four consecutive weeks commencing within ten days of recording the NOD;

- personally **deliver** a copy of the NOD to the borrower within ten days of recording or before publication is completed; or

- **post** a copy of the NOD in a conspicuous location on the property and mail a copy of the notice to the buyer's last known address. [CC §2924b(d)]

Junior secured creditors also request NODs and Notices of Delinquency (NODq) to better protect their interests in the secured property against foreclosure and extended delinquencies allowed by a senior lender. [See Chapter 4]

Chapter 15 Hazard insurance proceeds

This chapter clarifies the lender's ability to apply the proceeds from a hazard insurance claim to the balance due on the loan, before and after foreclosure.

The right to rebuild vs. loan impairment

A homeowner owes $300,000 on a loan secured by a trust deed on his home, which is valued at $500,000. A well constructed aviary is attached to the home.

As required by the trust deed, the owner maintains a fire insurance policy on the real estate, listing the lender as an additional named insured.

The trust deed also contains a **hazard insurance provision** granting the lender the option to:

- retain any fire insurance proceeds and apply them to the loan; or
- release the proceeds to the owner for rebuilding. [See Form 450 §2.2 in Chapter 14]

A fire destroys the aviary, a $5,000 loss for the homeowner, but does not damage the home. After the fire, the value of the real estate is $495,000.

The homeowner decides not to replace the aviary.

To cover the loss from the fire, the homeowner's insurance carrier issues a check payable to the homeowner and the lender as called for in their policy. The owner informs the lender of his intention not to rebuild, and requests the check be endorsed to him.

The lender refuses, demanding the insurance proceeds be applied:

- to the outstanding balance of the debt; or
- to reconstruct the damaged structure.

The owner claims he is entitled to the proceeds since the debt owed to the lender on the note is adequately secured by the dollar value of the remaining property.

Can the lender apply the insurance proceeds to the balance due on the debt?

Yes! The lender has full control over the proceeds since:

- the owner elected not to restore the improvements after the fire; and
- the trust deed contains a provision stating the lender is entitled to apply the insurance proceeds to the loan balance. [Calif. Financial Code §§1227.3, 7462]

*Editor's note — Prior to 1987, a lender could not apply insurance proceeds to the loan balance unless he could show his security was impaired, despite the owner's election not to rebuild. [**Kreshek** v. **Sperling** (1984) 157 CA3d 279]*

However, statutes enacted to deregulate lenders in 1987 legislatively reversed the Kreshek ruling and removed the issue requiring a showing of impairment due to losses suffered from a fire or other hazard. Now the issue of impairment only arises when the lender challenges an owner's arrangements to rebuild destroyed improvements on the secured property.

Good faith cooperation implied

Since a trust deed is a contract, a trust deed is subject to an *implied promise* on the part of both the owner and the lender to act in good faith and deal fairly with one another. [**Milstein** v. **Security Pacific National Bank** (1972) 27 CA3d 482]

The lender and the owner, as the contracting parties to a trust deed, must:

- refrain from conduct which interferes with each other's performance of the trust deed provisions; and
- perform all acts contemplated in the trust deed to accomplish the objectives served by the trust deed – lender security from loss.

For instance, a lender cannot **automatically refuse** to release the proceeds to an owner who intends to reconstruct the destroyed improvements and restore the property to its value before it was damaged.

Election to rebuild when funds exist

An owner's real estate is valued at $500,000, with $450,000 owed on a note secured by a first trust deed.

Trust deed provisions require the owner to maintain a fire insurance policy which also lists the lender as a named insured.

Again, the trust deed further provides the lender can either:

- apply any fire insurance proceeds to the loan; or
- release the proceeds to the owner for rebuilding the improvements.

A fire totally destroys the improvements.

The value of the remaining real estate is $200,000. The total rebuilding costs are $300,000.

The policy provides sufficient coverage to fund the replacement of the destroyed improvements.

The owner decides to rebuild, but the lender exercises its option to apply the insurance proceeds to the loan balance.

The lender refuses to release the proceeds to the owner, claiming the owner cannot receive the funds and rebuild since the trust deed states the lender has the option to apply the proceeds directly to the loan balance.

However, the lender must allow the owner to rebuild, unless the lender can show the security will be impaired by the reconstruction of the improvements as proposed by the owner. [**Schoolcraft** v. **Ross** (1978) 81 CA3d 75]

If the insurance proceeds are sufficient to fully rebuild and replace the destroyed improvements, the lender's security interest will not be impaired. Thus, the lender's loan will be restored on completion of construction to the loan-to-value (LTV) ratio it had before the fire loss. [**People** v. **Redwood Baseline, Ltd.** (1978) 84 CA3d 662]

Failure to release the proceeds constitutes a breach of the lender's obligation to act in good faith and fair dealing. [Schoolcraft, *supra*]

Lender impairment

While the lender cannot refuse to allow the owner to rebuild when the security interest will be unimpaired by the rebuilding, the lender can demand assurance the owner will use the proceeds to complete the reconstruction.

If the fire damage was substantial, the lender could reasonably require the owner to:

- submit the reconstruction plans to the lender;
- hire a licensed contractor; and
- obtain a building permit.

In addition, the lender might require the contractor to provide the lender with a **performance bond** to ensure completion of the reconstruction.

During reconstruction, the lender may require the insurance proceeds be disbursed in progress payments. As each phase of reconstruction is completed, the lender or a builder's control would release payment for work performed.

Should the lender determine the reconstruction plans to be deficient, the lender has a good obligation to inform the owner why the plans are considered deficient, and allow the owner time to correct the deficiencies.

Failure to provide insurance

A lender can require an owner to carry fire insurance up to the replacement cost of the improvements, even if the costs exceed the loan amount or the current value of the property. [Calif. Civil Code §2955.5]

Consider an owner of real estate, encumbered by a trust deed containing an insurance provision, who fails to maintain adequate fire insurance to recover **replacement costs** of the improvements on the property.

Under the due-on-default acceleration clause in the trust deed, the lender may call the loan due for the owner's failure to maintain insurance. [See Form 450 §3.5 in Chapter 14]

However, the prudent lender is likely to rely on another trust deed provision allowing the lender to advance payment for fire insurance premiums when the owner fails to maintain adequate insurance, called a *future advances clause*, since the security is in danger of impairment. [See Form 450 §2.5 in Chapter 14]

Under the **future advances clause**, an owner who fails to maintain a fire insurance policy, as required by the trust deed, authorizes the lender to:

- take out an insurance policy;
- pay the premiums;
- add the premiums paid to the loan balance; and
- demand immediate reimbursement. [Calif. Insurance Code §171]

If the owner fails to tender the amounts advanced on the lender's demand for reimbursement, the lender can call the loan, and if it is unpaid, initiate foreclosure proceedings. [Fin C §§1227.2, 7461]

Covered for value, not replacement

Now consider an owner of real estate whose hazard insurance coverage is limited to the current market value of the real estate, but is insufficient to cover the replacement cost of the improvements.

Real estate values in the area surrounding the property have declined or replacement costs have risen faster than real estate values. Thus, the replacement cost of the home now exceeds the current fair market value of the land and improvements.

A substantial portion of the improvements covered by the policy are destroyed.

The owner intends to rebuild the destroyed improvements, but the insurance proceeds are insufficient to cover the costs of reconstructing the same improvements.

Further, the owner cannot contribute funds to cover the shortage between the full replacement cost of the destroyed improvements and the insurance proceeds.

Since the insurance proceeds alone will not cover the costs of replacing the destroyed improvements with comparably valued improvements, the loan-to-value (LTV) ratio will not be restored. Thus, the lender's security interest is impaired as a result of the destruction and inadequate coverage.

The lender has two remedies when the insurance proceeds are inadequate to restore the lender's LTV ratio:

- apply the insurance proceeds to the loan balance; or
- call the loan due since the owner failed to maintain adequate coverage.

If the lender calls the loan due, the lender must underbid at the foreclosure sale by the amount of the coverage if the lender is to collect the insurance proceeds.

A full-credit bid at the trustee's sale satisfies the entire debt, leaving the lender with no loss on the loan, despite any potential losses to be incurred by the lender on a later resale of the real estate for a price less than the amount bid. [**Altus Bank** v. **State Farm Fire and Casualty Company** (1991) 758 F. Supp. 567]

Failure to require insurance

Consider an owner of real estate who maintains a hazard insurance policy as required by the trust deed encumbering the property.

The hazard insurance provision in the trust deed does not require the owner to maintain **earthquake insurance**. However, the owner purchases an earthquake insurance policy. Without the owner's consent, the insurer includes the lender as a beneficiary of the earthquake policy.

An earthquake seriously damages the property and the owner defaults on the trust deed loan.

To cover the earthquake damage, the insurer issues a check payable to the lender and the owner.

The owner requests the lender to endorse the check to the owner. The lender refuses, claiming it has the right to either apply the proceeds toward the repair of the property or to the unpaid loan balance.

The owner claims the lender must endorse the check to him since the hazard insurance provision in the trust deed did not require the owner to maintain earthquake insurance for the benefit of the lender.

The lender claims it is entitled to the insurance proceeds under the waste provision in the trust deed since the lender's security for the trust deed loan was destroyed by the earthquake.

Is the lender entitled to the insurance proceeds?

No! The lender is not entitled to the insurance proceeds since:

- the hazard insurance provision did not require the owner to maintain earthquake insurance; and

- the lender was named as a beneficiary of the earthquake insurance policy in error. [**Ziello** v. **Superior Court** (1995) 36 CA4th 321]

Also, the waste provision in the trust deed only allowed the lender to sue the owner should the lender's security interest become impaired due to the owner's action of committing waste.

To ensure the lender is covered for property damage due to hazards such as fires and earthquakes, the hazard insurance provision in the trust deed must state each type of hazard which must be covered. [Ziello, *supra*]

Chapter 16 — Impound accounts

This chapter discusses the lender's use of an impound account provision in a trust deed to collect funds for annually recurring, lump sum property expenses.

Taxes and premiums paid through the lender

The seller of a single family residence (SFR) receives an offer from a buyer who intends to occupy the property as his primary residence.

Terms for payment of the purchase price include a cash down payment of less than 20%. To finance the purchase, the buyer assumes the existing first trust deed (or obtain purchase-assist financing) and executes a carryback note and trust deed in favor of the seller for the balance of the purchase price.

Thus, the loan-to-value (LTV) ratio of the combined first trust deed loan and the seller carryback is more than 80%.

Following a review of the seller's net sheet with his listing agent, the seller voices concern as to whether his net sales proceeds from the cash down payment will be adequate to cover his out-of-pocket expenditures for the property taxes, hazard insurance premiums and first trust deed payments should the buyer fail to pay them.

The buyer appears credit-worthy and financially capable of carrying the costs of owning the property (based on income to debt ratios of 31% for mortgage payments and 40% for all debts). However, the buyer's failure to pay property taxes and insurance premiums would **impair** the trust deed lien securing the carryback note, a risk of loss borne by the seller. If the seller were to pay these delinquencies, called a *future advance*, the amounts become part of the debt secured by the carryback trust deed since they are to be reimbursed by the buyer.

The seller believes he must minimize the risk of the buyer's default by insisting on a larger down payment. However, the seller's broker is concerned the seller may lose the buyer if he counters with an increase in the down payment.

As an alternative, the seller's broker suggests the seller consider a counteroffer to modify the terms in the buyer's offer by including an *impound provision* in the carryback trust deed, among other provisions sought by the broker to care for and protect his seller's interests.

An **impound provision** calls for taxes and insurance to be fully prepaid in monthly installments to the seller, in addition to principal and interest on the note, in a total monthly payment called PITI (principal, interest, taxes and insurance).

Can the seller enforce an impound provision for taxes and insurance if the SFR buyer accepts?

Yes! An impound account can be required and enforced by a carryback seller as a provision in a trust deed lien on an owner-occupied SFR when the principal of the first trust deed loan and the carryback note total more than 80% of the property's value. [Calif. Civil Code §2954(a)]

Under an impound provision in a trust deed lien on any real estate, the impound payments made by the buyer accumulate sufficient funds in advance for the payment of:

- property taxes and bond assessments; and
- hazard and mortgage insurance premiums. [CC §2954]

Impound account established

An owner of real estate subject to a trust deed is obligated to timely pay the taxes, bond assessments and insurance premiums under the trust deed provisions which protect the beneficiary of the trust deed lien against *impairment* of his interest in the property.

An impound account provision is included in the trust deed by way of an addendum. With an impound account, the security for the debt will not be impaired by defaults in taxes, assessment bonds, and insurance premiums should the beneficiaries have to initiate foreclose on the real estate to enforce collection of the debt. [See Form 455 accompanying this chapter]

The owner's payment of taxes and insurance premiums before they become delinquent is required by the trust deed, even if the trust deed does not include an impound account provision to accumulate funds in advance for the payment of taxes and insurance.

However, by establishing an impound account, the real estate owner must each month prepay a pro rata share of taxes and insurance premiums to the trust deed beneficiary, whether the beneficiary is a lender or a carryback seller. Impound payments are paid with and in addition to the regular monthly installment of principal and interest due on the note.

A lender or carryback seller secured by a trust deed on an **owner-occupied** single family residence (SFR) can only require the owner or buyer to agree to an impound account if:

- the combined principal amount of two or more notes secured by the real estate is 80% or more of the real estate's appraised value;
- the first trust deed note amount is 90% or more of the appraised value of the real estate;
- the owner becomes delinquent on two consecutive property tax installments [See **first tuesday** Form 455-1];
- the impound account is required by a state or federal agency; or
- the loan is made, guaranteed, or insured by a state or federal governmental lender or insurer. [CC §2954(a)]

For SFR situations where a beneficiary cannot require an impound account, the owner of the SFR may **agree** to an impound account. However, prior to the execution of the loan documents, carryback note and trust deed, the beneficiary must give the owner a written **impound account disclosure statement** notifying the owner:

- the impound account cannot be required as a condition to the funding of the loan or carrying paper; and

IMPOUNDS ADDENDUM
Taxes and Insurance

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the Deed of Trust

1.1 ☐ of same date, or dated __________, 20______, at _________________________________, California,

1.2 executed by ____, as the Trustor,

1.3 naming ____ as the Beneficiary.

AGREEMENT:

2. Trustor will pay Beneficiary, in addition to regular monthly installments on the Note secured by the Deed of Trust, a sum equal to one-twelfth (1⁄12) of the annual taxes levied on the property and the annual premiums for hazard insurance, mortgage insurance and other insurance required by the Beneficiary.

3. An initial deposit of $_______________ is required to establish the impound account.

4. Beneficiary will disburse money maintained in the impound account for the payment of taxes, assessments, and insurance premiums.

5. Any surplus amounts will be applied toward payment of the principal amount of the Note or future advances secured by the Deed of Trust.

I agree to the terms stated above.

Date: _____________, 20______

Trustor's Signature: _____________________________ Trustor's Signature: _______________________________

Trustor's Signature: ____________________________ Trustor's Signature: _______________________________

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- whether or not interest will be paid on the funds held in the impound account. [CC §2954(a); see **first tuesday** Form 455-3]

Canceling the impound account

Consider an owner of a single family residence (SFR) who agrees to pay his taxes and hazard insurance premiums into an impound account. The category of the property and its use by the owner does not allow the lender to require an impound account. No termination date is specified for the impound account.

Later, the owner notifies the lender he is canceling the impound account and will pay the taxes and hazard insurance premiums himself. The owner continues to make payments of principal and interest to the lender.

The lender returns the principal and interest payments and files a Notice of Default (NOD).

The owner reinstates the loan and makes the impound payments requested by the lender in protest. The owner then seeks to recover the impound payments as an overpayment, claiming the lender violated the owner's **right to cancel** the impound account by refusing to accept the payments of only principle and interest.

The lender claims the SFR owner cannot cancel the impound account since the owner agreed to a permanent impound account which could only be canceled with the lender's permission.

Can the owner cancel the impound account without the lender's approval?

Yes! The lender violated the SFR owner's right to cancel the impound account since the owner's consent to a permanent impound account was voluntary and **could not be required** on an owner-occupied SFR which did not qualify for mandatory inclusion by the lender. [**Kirk** v. **Source One Mortgage Services Corporation** (1996) 46 CA4th 483; CC §2954(a)]

Impound payment requirements

When provisions in a trust deed encumbering any type of real estate establish an impound account calling for taxes and insurance premiums, the **beneficiary must**:

- set the amount of the **initial deposit** and **monthly payments** to be made into the impound account — the amounts must be reasonably necessary to accumulate sufficient funds to pay the property taxes, assessments and insurance premiums when due; and

- from the funds received, pay property taxes before they are delinquent and insurance policy premiums before they are canceled. [CC §2954.1]

The **initial deposit** in an impound account on a note secured by any type of real estate, whether a loan or a carryback, is capped at:

- the total dollar amount of payments for taxes and insurance premiums prorated for the period running from the date their payment was last due to the date of the first installment due on the note; plus

- a reserve of one sixth of the total dollar amount of payments due for the period running from the date the last payments for property taxes and insurance premiums were due to the date of the first payment under the note.

Further, the **monthly impound payments** for an impound account on a note secured by any type of real estate are capped at:

- one twelfth of the estimated annual payments for taxes and insurance; plus

- any deficiency in the reserve of one sixth of the total annual payments for property taxes and insurance premiums. [CC §2954.1(a); 12 United States Code §2609]

Editor's note — The Real Estate Settlement Procedures Act (RESPA) has established regulations for impound accounts. [12 USC §2605(g); 24 Code of Federal Regulations §3500.17]

All federally related loans must comply with the requirements. A federally related loan subject to RESPA is a loan secured by a trust deed on one-to-four unit residential property or a mobilehome.

A lender making a federally related loan is subject to RESPA regulations if the lender:

- *annually invests or originates loans retained in the lender's portfolio totaling over $1,000,000;*

- *is a federally insured bank or thrift;*

- *is making loans eligible for purchase in the secondary mortgage market by the Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) or the Government National Mortgage Association (Ginnie Mae); or*

- *is making loans insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA). [24 CFR §3500.2(a)(3)]*

While a real estate broker making or arranging federally related loans is subject to RESPA requirements, a ***carryback seller*** *is not. However, the regulations do serve as one method for handling impounds.*

Refunds of excess impound amounts

Any funds accumulated in the impound account which exceed the reasonable amount necessary to pay the annual taxes and insurance premiums must be refunded within 30 days of the surplus being incurred, unless the owner and the beneficiary have agreed to apply the funds elsewhere. [CC §2954.1(b)]

For example, a beneficiary and owner can agree in the impound provision to either:

- credit the excess funds in the impound account to the principal; or

- retain the excess in the impound account to cover any later deficiencies in the impound account. [See Form 455 §4]

However, a written agreement for the use of the **surplus impound funds**, other than an immediate refund, can be rescinded by either the owner or beneficiary at any time. [CC §2954.1(b)]

Deficiency in the impound account

A beneficiary can require an owner of any type of real estate to pay additional amounts to cover a deficiency in the impound account. [CC §2954.1(c)]

However, a carryback seller under a land sales contract which documents the sale of a buyer-occupied single family residence (SFR) cannot increase the monthly payments until the buyer receives from the seller:

- an itemized accounting of the money currently in the impound account;

- a statement of the new monthly impound payments; and

- notice of the reasons the increase is necessary. [CC §2954]

If the amount in the impound account is insufficient to pay the property taxes and insurance premiums due to the owner's failure to pay, the impound account provision may call for the beneficiary to advance the deficient amounts.

The beneficiary and owner can agree in the terms of the trust deed that impound amounts advanced by the beneficiary to protect the security constitute a future advance. [See Form 450 §2.5 in Chapter 14]

When the beneficiary makes a future advance, the owner is obligated to reimburse the beneficiary on demand. [See **first tuesday** Form 454]

Figure 1

Impound account deposit

(Determines largest shortfall for disbursements)

	pmt	disb	bal
June	0	0	0
July	$417	0	$417
August	$417	0	$833
September	$417	0	$1,250
October	$417	0	$1,667
November	$417	0	$2,083
December	$417	$4,300	-$1,800
January	$417	0	-$1,383
February	$417	0	-$967
March	$417	0	-$550
April	$417	0	-$133
May	$417	$700	-$417
June	$417	0	$0

Figure 2

Adjusted balances

(Lowest initial impound balance)

	pmt	disb	bal
June	0	0	$1,800
July	$417	0	$2,217
August	$417	0	$2,633
September	$417	0	$3,050
October	$417	0	$3,467
November	$417	0	$3,883
December	$417	$4,300	$0
January	$417	0	$417
February	$417	0	$833
March	$417	0	$1,250
April	$417	0	$1,667
May	$417	$700	$1,383
June	$417	0	$1,800

All advances made by the beneficiary become a secured debt, and if the debt is not paid, the beneficiary may call the loan due by recording a NOD to start foreclosure.

Annual accounting

A seller carrying back a note and trust deed on one-to-four unit residential property with an impound provision must provide the buyer with an **annual impound accounting** within 60 days after the end of the calendar year. [CC §2954.2]

The annual impound accounting must itemize:

- the amount received and applied to interest and principal;
- money received and disbursed from the impound account for the payment of property taxes, bond assessments and insurance premiums; and

- any late charges. [CC §2954.2(a)]

A buyer of property on an impounded installment sale is entitled to the annual impound accounting statement without charge or prior request. [CC §2954.2]

The lender or carryback seller who furnishes the owner with an itemized monthly accounting of the principal, interest and impound account complies with the annual statement requirements. [See **first tuesday** Form 455-2]

For impound accounts on owner-occupied single family residence (SFR) loans, excluding seller carrybacks, the lender is only required to furnish an itemized accounting within 60 days of the end of the calendar year if requested by the owner. The lender may not charge the owner for the annual accounting. [CC §2954(b)]

Figure 3

Initial deposit for impound account

(Advance deposit to build reserves)

	pmt	disb	bal
May (deposit)	$2,633	0	$2,633
June	0	0	$2,633
July	$417	0	$3,050
August	$417	0	$3,466
September	$417	0	$3,883
October	$417	0	$4,300
November	$417	0	$4,716
December	$417	$4,300	$833
January	$417	0	$1,250
February	$417	0	$1,666
March	$417	0	$2,083
April	$417	0	$2,500
May	$417	$700	$2,216
June	$417	0	$2,633

The one-to-four unit residential property owner is entitled to more than one annual accounting, such as a monthly accounting, with a written request to the lender or carryback seller and on payment, in advance, of a fee of:

- $0.50 per statement when requested in advance on a monthly basis for at least one year;
- $1 per statement when requested for only one month; and
- $5 for a single cumulative statement giving all the monthly information back to the last statement given. [CC §2954(b)]

Both the lender and the carryback seller on one-to-four unit residential property must include in the annual accounting a statement in 10-point type notifying the owner of the additional accounting, for a fee, he can request from the lender or carryback seller. [CC §2954.2(a)]

Interest accruing on impound accounts

When the property securing a loan is a one-to-four unit residential property and the loan has an impound account, the financial institution hold-

ing the loan must pay 2% annual **simple interest** on any balance in the impound account. A fee cannot be charged for maintaining the impound account if it would cause the interest received on the account to fall below 2%. [CC §2954.8(b)]

A financial institution includes a bank, savings and loan association (S&L), credit union, or any other person or organization making loans secured by one-to-four unit residential property. [CC §2954.8(c)]

However, **carryback sellers** are not financial institutions, and are not required to pay interest on impound accounts established in a carryback trust deed.

Impounds and trust funds

Consider a carryback seller on any type of real estate whose buyer agrees to an impound account. The seller receives the monthly payments of principal, interest and impounds for the payment of property taxes, bond assessments and insurance premiums.

Is the seller required to maintain a separate bank account for the impounds?

No! Unlike trust funds, a carryback seller or lender may commingle the owner's impounds with its **general funds** and retain all the benefits from these funds.

However, the impound funds must remain in the state of California. If invested, the funds can only be invested with residents of the state or partnerships and corporations which are engaged in business in the state. [CC §2955]

On real property sales contracts carried back by sellers, also called *land sales contracts*, the impound funds must be held in a **trust account**. The trust funds can only be disbursed for property taxes and insurance premiums unless the buyer and all lienholders of record agree otherwise. [CC §2985.4]

A lender with a first trust deed on any type of real estate may deposit impound accounts in an out-of-state depository insured by the Federal Deposit Insurance Corporation (FDIC), if the lender is:

- Fannie Mae, Ginnie Mae, Freddie Mac, FHA or VA;
- licensed and certified under federal or state law to do business related to banking;
- a pension fund or profit sharing welfare fund worth $15,000,000 or more;
- a corporation with publicly traded securities;
- the California Housing Finance Agency or any local housing authority;
- a **syndication** of the above investors organized to purchase promissory notes;
- a **real estate broker** selling all or part of the note to lenders described in this section that may deposit impound accounts in an out-of-state depository; or
- a licensed residential mortgage lender acting under the authority of its license. [CC §2955(b)]

Calculating impound amounts

One method used by lenders and carryback sellers for calculating an impound account balance is found in Real Estate Settlement Procedures Act (RESPA) regulations. [24 CFR §3500 Appendix E]

Consider the sale of any type of real estate in which the seller will carry back a note and trust deed. The carryback seller will also maintain an impound account.

The buyer will incur:

- annual property taxes of $4,300, due on December 10; and
- an annual hazard insurance premium of $700, due on May 15.

Escrow will close on May 15 and the first payment is due to the carryback seller on the first of July.

The monthly impound balances are calculated to set the **initial deposit** necessary to avoid negative impound balances during any month due to disbursements.

The initial deposit for the impound account and the monthly impound payments are calculated based on whether:

- each disbursement by the seller from the impound account will be timely made; and
- the payments into the impound account by the buyer are one twelfth of the total annual property taxes and insurance premiums due. [See Figure 1]

From the balance in the impound calculated monthly in Figure 1, the lowest monthly balance — a deficiency — is to be **initially deposited** by the owner to keep the impound account balance from dropping below zero during any one month. [See Figure 2]

In our example, December has the lowest monthly balance of $1,800. [See Figure 1]

Also, a permissible **reserve balance** equal to one sixth of the total annual disbursements is added to the impound account balances.

In our example, the reserve is $833 — one sixth of $5000 in taxes and insurance premiums.

Thus, the initial deposit in the impound account is the $1,800 deficiency (Figure 1) and the one sixth reserve, which equals $2,633 (Figure 3). During the first year of loan payments, the buyer's monthly payment into the impound account is $417.

Impounds on AITDs

Consider a seller who will remain responsible for making payments on an underlying loan by carrying back an all-inclusive trust deed (AITD).

The wraparound note and trust deed will give the carryback seller additional protection against the buyer defaulting on the first trust deed payments, and the seller not learning of the default for several months.

The existing underlying loan contains an impound account provision for taxes and insurance. The seller currently pays the monthly impound amount in addition to regular installments of principal and interest.

Impounds on the underlying loan will continue to be paid by the seller. The AITD must also be impounded, so the seller is reimbursed monthly by the buyer, a pass-through of the amount due to be paid to the first trust deed lender.

Chapter 17 — Assignment of rents provision

This chapter discusses the uniform rules for a lender's enforcement of an assignment of rents provision to collect rents and apply them to the loan on a default on the trust deed.

The lender's rent collection on default

A clause called an *assignment of rents provision* is commonly placed in trust deeds. The clause creates a lien on unpaid rents as additional security to the real estate described in the trust deed. Rents are property other than the secured real estate.

The **assignment of rents provision** in a trust deed transfers to the beneficiary (lender) the right to collect unpaid rental income from the income-producing real estate described in the trust deed **following a default** on the trust deed.

The assignment of rents provision is legally referred to as an *assignment of rents, issues and profits clause*, but is limited to rent without concern for other issues or profits.

Two types of the assignment of rents provision exist:

- an *absolute assignment*; and
- a *conditional assignment*.

However, the distinction between the two types of assignment of rents provisions is not of concern to the holder of a trust deed that was recorded after January 1, 1997.

Either type of assignment of rents provision contained in a trust deed executed and delivered after 1996 creates a **present security interest** in the rents from existing and future rental and lease agreements for possession of the secured real estate, generally referred to as a *lien on rents*. [Calif. Civil Code §2938(a)]

The statutory scheme provides for **uniform enforcement** of all post-1996 assignment clauses, no longer leaving the details to the trust deed contract.

For those assignment of rents provisions recorded before 1997, the rules based on the distinctions between the two types of rent clauses still govern their **perfection and enforcement**.

Editor's note — Unlike liens on real estate or personal property, enforcement of a security interest in rents had not been controlled by the state prior to 1997.

Like statutory schemes which control a trustee's foreclosure sale when enforcing a power-of-sale provision in a trust deed, and the creditor's sale of personal property when used as collateral for a loan, the statutory scheme for enforcement of assignment of rents provisions entered into after January 1, 1997, controls the procedures for perfecting the lien and enforcing the collection of rents.

Absolute assignments pre-1997

An *absolute assignment* of rents is a **present transfer** of all the owner's rights, title and interest in the rents generated by the real estate.

To be enforceable, a present transfer of ownership rights in the rents must first be *perfected*. The transfer of title to the rents is **perfected by recording** the trust deed which contains the absolute assignment of rents provision. [CC §2938]

However, the absolute assignment of rents provision by its wording **reserves** the owner's right to collect and use the rents until the owner defaults on the note or trust deed.

If the owner defaults, the lender can enforce its ownership of the rents and collect the rents. [CC §2938(c)]

Under an absolute assignment of rents, the lender is entitled to collect the rents **directly from the owner or tenants** without first taking possession of the real estate or using a court- appointed receiver.

Thus, the lender can directly enforce the absolute assignment of rents clause by making a written demand on the owner or tenant for the rent, an aspect of the post-1996 law.

Conditional pre-1997 assignments

A *conditional assignment* of rents provision in a trust deed **creates a lien** on all rents in favor of the lender. The rents become additional security to the real estate which is also liened by the trust deed.

As a lien, the conditional assignment of rents is **not a transfer** of any ownership rights to collect the rents, as occurs under an absolute assignment of rents provision. Instead, a lender merely holds a lien on the rents, as he does on the real estate — with no ownership of them. The lien on rents gives the lender the right to enforce collection of the rents only if he directly or indirectly **takes possession** of the real estate on a default on the trust deed. The lender can take possession and collect the rents himself, or more preferably, use a court-appointed receiver to take possession of the property and collect the rents.

For conditional assignments entered into before January 1, 1997, judicial confusion as to the distinction between the application of the terms *perfection* and *enforcement* existed. The two different types of assignment clauses led to chaos in perfection and enforcement of the lender's right to rents.

However, for all conditional assignment of rents provisions entered into between January 1, 1993 and January 1, 1997, the lender perfected his lien on the rents **by recording** the trust deed which contained the conditional assignment provision. [CC §2938.1]

Figure 1 *Excerpt from* ***first tuesday*** *Form 450— Long Form Trust Deed and Assignment of Rents*

3.4 ASSIGNMENTS OF RENTS — Trustor hereby assigns and transfers to Beneficiary all the rights, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this Deed of Trust.

Prior to a default on this Deed of Trust by the Trustor, Trustor shall collect and retain the rents. On default by Trustor, Beneficiary shall immediately be entitled to possession of all unpaid rents.

Current assignment of rents scheme

A trust deed recorded after 1996 which contains any type of assignment of rents provision establishes a **present security interest** — a *lien* — on existing and future unpaid rents generated by the property encumbered by the trust deed lien, regardless of whether the assignment is called absolute, absolute conditioned on default, additional security, a lien, etc. [CC §2938(a)]

The assignment of rents provision may be in a separate **lien agreement** but is usually placed in the trust deed describing the real estate involved. [See Figure 1]

Once the assignment is recorded it:

- gives *constructive notice* of the lender's security interest in the rents; and
- is *fully perfected* even though the provision states the lien is unenforceable until a default occurs on the note or trust deed. [CC §2938(b)]

Perfection gives priority to the lender's security interest in the rents over any security interest in the rents later acquired by other creditors or owners of the real estate.

Default on post-1996 recordings

A default under a post-1996 trust deed triggers the assignment of rents provision, allowing the lender to **collect the rents.** The lender may take any of several enforcement steps, including:

- delivering a written **demand for rents** to the owner, with a copy to all persons holding a recorded interest in the rents [See Form 456 accompanying this chapter];
- delivering a written **demand for rent** to the tenants with a copy to the owner and all persons holding a recorded interest in the rents, such as senior and junior trust deed holders [See Form 457 accompanying this chapter];
- having a **receiver appointed** judicially; or
- taking **possession** of the property and collecting rents nonjudicially, called *self-help*. [CC §2938(c)]

Whether the lender seeks the appointment of a receiver, takes possession of the property himself, or delivers a notice demanding the rents, the lender has *commenced enforcement* of his right to the rents. From the moment the lender **commences enforcement** of his right to collect the rents by taking one of these actions, the lender is entitled to collect and receive all rents accrued and unpaid from the time enforcement was commenced. [CC §2938(c)]

The written demand served on a tenant for collection of the rent must be made on a statutorily prescribed form, signed under penalty of perjury by the lender or the lender's agent. [See Form 457]

Editor's note — When an owner defaults on a pre-1997 ***absolute assignment (present transfer)*** *clause, the lender may use any of the 1997 statutory enforcement procedures to properly enforce its rights to the rents.*

However, for enforcement of a pre-1997 ***conditional assignment (lien provision)****, the lender is limited to taking possession of the property by:*

- *self-help; or*
- *a court-appointed receiver.*

*Under a pre-1997 conditional assignment provision, the owner of the secured real estate remains entitled to collect and keep the rents until the lender takes physical possession of the property or a receiver is appointed. [****Childs Real Estate Company Inc.*** *v.* ***Shelburne Realty Co.*** *(1943) 23 C2d 263]*

Thus, a trust deed lender with a pre-1997 conditional assignment on income-producing property should consider amending the clause in a separate recorded document as part of any future negotiations with the owner or an assuming buyer. The recorded post-1996 amendment is then enforceable under the new statutory scheme of notices to collect rent.

Regardless of whether the method of enforcement used is judicial or nonjudicial, a lender's enforcement of its collection rights under an assignment of rents provision does not constitute an action for purposes of the *one-action rule.* The **one-action rule** requires the trust deed lender to first resort to foreclosure on the real estate before pursuing other collection remedies. Thus, enforcement of the assignment of rents provision by collecting rents does not bar a lender from later foreclosing on the real estate or, on recourse loans, seeking a deficiency judgment against the owner. [CC §2938(e)]

Written demand on the tenant

After a lender makes a written demand for rent on a tenant, residential or non-residential, all unpaid rents due or becoming due in the future must be paid to the lender, unless:

- the tenant has in good faith previously paid, or within 10 days following receipt of the demand, pays the rent to the owner;
- the tenant previously received a demand for the rents from a different lender;
- a court order directs the tenant to pay rent differently; or
- the lender cancels his demand for the rents. [CC §2938(d); see **first tuesday** Form 458]

Payment of rent to the lender under the lender's demand fully satisfies the tenant's obligation to pay rent to the landlord under his lease or rental agreement.

The lender who makes a demand on a **residential tenant** to pay rents should concurrently make a demand on the owner to forward to the lender any rents collected by the landlord after receiving the lender's notice.

By serving a demand for rents on both the residential tenant and the owner, the owner becomes personally liable for those rents the residential tenant pays to the owner within 10 days after the tenant receives the demand notice.

Conversely, **nonresidential tenants** remain liable to the lender for rent if the nonresidential tenant disregards the lender's notice and continues to pay the rent to the owner. [CC §2938(d)(2)]

DEMAND ON OWNER TO PAY RENT TO LENDER

Under Assignment of Rents

DATE:_____________, 20______, at____, California.

To Borrower: ____

1. ____, as the Lender, is the Assignee of leases, rents, issues, and profits under

1.1 a document entitled ____,
recorded on __________________, as Instrument No. _______________,
in ____ County Records, California.

2. In accordance with Calif. Civil Code §2938(c)(4), Borrower is hereby directed to pay to Lender at ____, all rents due Borrower under Borrower's leases or other rental agreements with Tenants

2.1 for the occupancy of the property at____
____.

3. Rents due include rents which are past due and payable and rents which become due and payable on or after the date Borrower receives this demand.

I declare under penalty of perjury that I have the authority to demand the rents, and that the assignment of leases, rents, issues or profits executed by Borrower or his predecessor in interest is being enforced pursuant to Calif. Civil Code §2938.

Date:_____________, 20______

Executed at:____, California.

Lender:____

By: ____

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By also noticing the owner, the lender protects itself against the tenant's failure to comply with the demand, since demand on the owner always imposes personal liability on the owner for his failure to pay forward to the lender the rent the owner later collects.

Lender payment of operating costs

Consider a lender who enforces the assignment of rents provision by making a written **demand on only the owner** to collect and hand over the rents. [See Form 456]

The lender does not seek the appointment of a receiver, does not take possession of the property himself and does not make a demand on the tenants for rent.

After receiving the lender's demand to hand over the rents, the owner voluntarily does so. In turn, the owner makes a **written demand** on the lender to pay the taxes and insurance premiums, as well as operating costs incurred by the owner of the property, for repair, maintenance and security.

Must the lender pay the ownership costs demanded by the owner?

Yes! If rent is collected under an assignment of rents provision without the appointment of a receiver (who would then be the one to pay the operating costs), the owner may make a demand on the lender to pay the reasonable costs the owner has incurred to **preserve the property** — including the payment of taxes and insurance premiums — which the lender is then obligated to pay from whatever rents the lender collects. [CC §2938(g)(1)]

Costs which are considered reasonable to **preserve and protect** the property include:

- pool maintenance;
- common area maintenance (CAM), whether paid through the rents or paid by the owner;
- repair costs, such as plumbing and roofing; and
- security patrols, if already provided by the owner before the default.

The lender's payment of costs on a demand from the owner does not make the lender a *mortgagee-in-possession*, or otherwise obligate the lender to operate or manage the property.

The owner of property subject to a trust deed and assignment of rents lien has the **primary duty** to operate and manage the property should the lender receive the rents and pay some of the property's operating and ownership expenses, unless a receiver is appointed or the lender takes physical possession of the property. [CC §2938(g)(2)]

Further, the lender's obligation to pay reasonable property operating expenses on written demand from the owner remains until:

- a receiver is appointed, in which case the receiver pays all further costs incurred to operate the property; or
- the lender ceases to enforce its assignment of rents clause. [CC §2938(g)(3)]

However, the lender is under no legal obligation to have a receiver appointed in order to enforce its assignment of rents provision. [CC §2938(g)(4)]

Also, no penalties exist should the lender fail to pay costs on the owner's written demand. However, the lender is liable to the owner for reimbursement of the costs.

Editor's note — A court-appointed receiver is basically a new owner-operator of the property, charged with the responsibility for the management and care of the property for the duration of the receivership.

Most lenders secured by a rents clause on rental properties have neither the administrative expertise (staff) nor the will to enforce the clause or receive a voluntary tender of the rents from the owner.

The lender's risk when disrupting tenants

Serving the tenants with a **statutory notice** to pay the rents to the lender seems to be an uncomplicated process for the trust deed lender.

DEMAND ON TENANT TO PAY RENT TO PARTY OTHER THAN LANDLORD

(Section 2938 of the Civil Code)

DATE:_____________, 20______, at____, California.

To Tenant: ____
(Name of Tenant)

Property Occupied by Tenant ____
(Address)

Landlord ____
(Name of Landlord)

Secured Party ____
(Name of Secured Party)

Address ____
(Address for Payment of Rent to Secured Party and for Further Information)

1. The secured party named above is the assignee of leases, rents, issues, and profits under a document entitled ____, dated __________________, and

1.1 recorded on _______________________, as Instrument No. _______________, in the Official Records of ____County, California.

1.2 You may request a copy of such assignment from the secured party at ___________________________.

2. THIS NOTICE AFFECTS YOUR LEASE OR RENTAL AGREEMENT RIGHTS AND OBLIGATIONS. YOU ARE THEREFORE ADVISED TO CONSULT AN ATTORNEY CONCERNING THOSE RIGHTS AND OBLIGATIONS IF YOU HAVE ANY QUESTIONS REGARDING YOUR RIGHTS AND OBLIGATIONS UNDER THIS NOTICE.

3. IN ACCORDANCE WITH SUBDIVISION (C) OF SECTION 2938 OF THE CIVIL CODE, YOU ARE HEREBY DIRECTED TO PAY TO THE SECURED PARTY, ____
AT____,
ALL RENTS UNDER YOUR LEASE OR OTHER RENTAL AGREEMENT WITH THE LANDLORD OR PREDECESSOR IN INTEREST OF LANDLORD, FOR THE OCCUPANCY OF THE PROPERTY AT
____
WHICH ARE PAST DUE AND PAYABLE ON THE DATE YOU RECEIVE THIS DEMAND, AND ALL RENTS COMING DUE UNDER THE LEASE OR OTHER RENTAL AGREEMENT FOLLOWING THE DATE YOU RECEIVE THIS DEMAND UNLESS YOU HAVE ALREADY PAID THIS RENT TO THE LANDLORD IN GOOD FAITH AND IN A MANNER NOT INCONSISTENT WITH THE AGREEMENT BETWEEN YOU AND THE LANDLORD.

3.1. IN THIS CASE, THIS DEMAND NOTICE SHALL REQUIRE YOU TO PAY TO THE SECURED PARTY,
____
ALL RENTS THAT COME DUE FOLLOWING THE DATE OF THE PAYMENT TO THE LANDLORD.

4. IF YOU PAY THE RENT TO THE UNDERSIGNED SECURED PARTY ________________________________, IN ACCORDANCE WITH THIS NOTICE, YOU DO NOT HAVE TO PAY THE RENT TO THE LANDLORD. YOU WILL NOT BE SUBJECT TO DAMAGES OR OBLIGATED TO PAY RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT SECURED PARTY.

5. **FOR NONRESIDENTIAL TENANTS**: IF YOU PAY ANY RENT TO THE LANDLORD THAT BY THE TERMS OF THIS DEMAND YOU ARE REQUIRED TO PAY TO THE SECURED PARTY, YOU MAY BE SUBJECT TO DAMAGES INCURRED BY THE SECURED PARTY BY REASON OF YOUR FAILURE TO COMPLY WITH THIS DEMAND, AND YOU MAY NOT BE DISCHARGED FROM YOUR OBLIGATION TO PAY SUCH RENT TO THE SECURED PARTY. YOU WILL NOT BE SUBJECT TO SUCH DAMAGES OR OBLIGATED TO PAY SUCH RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT ASSIGNEE.

6. Your obligation to pay rent under this demand shall continue until you receive either:

6.1. A written notice from a court directing you to pay the rent in a manner provided therein; or

6.2. A written notice from the secured party named above cancelling this demand.

7. The undersigned hereby certifies, under penalty of perjury, that the undersigned is an authorized officer or agent of the secured party and that the secured party is the assignee, or the current successor to the assignee, under an assignment of leases, rents, issues, or profits executed by the landlord, or a predecessor of interest, that is being enforced pursuant to and in accordance with Section 2938 of the Civil Code.

Executed at: ____, California,

this ____ day of ____________, 20_____.

Name:____

Title: ____

While seemingly straight forward, notice to the tenant can lead to more involvement for the lender than would have occurred had he only made a demand on the owner or sought the appointment of a receiver.

Lenders may view the statutory notice for demanding rents from tenants as a fast and easy way to force the owner into curing a default, and as a way to protect their secured position on the rents.

But before the demand is delivered to the tenants, the lender must, as a practical matter:

- obtain a list of tenant names and addresses; or
- hand deliver the demand to each tenant to get the tenant's name, and then insert the tenant's name on the form before handing it to the tenant.

The lender must also conduct a **title search** for the names and addresses of the owners of record and lenders with a recorded interest in the rents. Title insurance companies will conduct this search for a fee.

Here a problem is created: once the lender makes a demand on a tenant, the demand will adversely affect the income flow from the property, making a cure of the default more difficult.

For example, consider an owner who defaults on a note additionally secured by an assignment of rents provision in a trust deed. The owner's default is on a monthly payment and the result of an unintentional oversight.

The lender informs the owner of the delinquency. However, before the owner cures the default, the lender serves a statutory notice on the tenants demanding the rents be paid to the lender.

When the tenants receive the demand for rent, the relationship between the owner and the tenants, which is often tenuous, is adversely disrupted. A tenant's confidence in the owner is diminished by the demand for rent notice.

Some tenants may consider relocating to other property (and some actually do) since the demand for rent raises concerns about the owner's solvency and his ability to maintain the property and provide security. In essence, the tenant may believe a change of ownership is underway, which is a destabilizing event under the best of circumstances since it creates uncertainties.

When tenants leave, the lender will experience a deterioration in the flow of income from the property since replacement tenants will not be on notice to pay rent to the lender. The lender will then have to make a demand on the replacement residents and risk further disruption of the landlord/tenant relationship with the replacement tenant — unless disruption is the lender's intent.

Instead of immediately serving the demand on the tenants, the lender should first determine whether the owner's default was merely an **infrequent delinquency** or a **serious default** worthy of the draconian step into the collection of rents and foreclosure on the real estate.

To investigate the nature of the tenant's default on the rent payment, the lender must contact the owner. The lender's collection effort requires staff, analysis and a pre-foreclosure workout ethic, not a knee-jerk, automatic foreclosure/collection reaction in retaliation.

If the default is more serious than an oversight or temporary cash-flow deficiency, the lender should seek to work out the default or establish a period of time for the owner to straighten out his financial affairs. Over a short period of time, such as a couple of months, the secured lender has little to lose but patience.

Property maintenance issues

Sending a demand for rent notice to a tenant also savages a lender's relationship with an owner since "notice" is perceived as a hostile event unless a meaningful dialogue first took place between the lender and owner.

To compound the hostilities, the owner may burden the lender with bills to be paid, whether the lender gives the demand notices for rent to the tenants, the owner, or both.

Further, if tenants have maintenance or security problems, the owner might refuse to correct them due to a lack of rental income to pay the bills, and simply in frustration refer the tenants to the lender, another example adversely affecting the tenant/landlord relationship.

The lender may then feel obligated to respond as would a property manager, even though the lender is not in possession of the property and the owner is still responsible for its operation. [CC §2938(g)(2)]

If the lender finds collecting the rents is necessary on the owner's default, the best course of action is to seek the **appointment of a receiver**, preferably selecting a licensed real estate broker experienced in property management.

When a lender makes the decision to collect rents through a receiver, the lender should immediately serve a notice on the owner demanding the rents. The demand on the owner establishes the date of enforcement and entitlement to unpaid rents from the owner.

By making a demand on the owner, the lender commences his claim to collect unpaid rents after a default occurs.

The lender can then file a *specific performance action* seeking a receiver. A receiver is appointed without the lender having to initiate a judicial foreclosure action or trustee's foreclosure on the real estate involved. [Calif. Code of Civil Procedure §564(b)(11)]

The court-appointed receiver is not considered an agent of the lender. Thus the lender is not liable for a receiver's mismanagement of the property. [**Tourny** v. **Bryan** (1924) 66 CA 426]

Although having a receiver appointed is not as easy nor as inexpensive as making a demand on the tenants or owner for rents, the lender will not be burdened with accounting for rent collections or disbursement, or property management situations, all of which take time and expertise to administer.

Accounting for rents received

All rents received by a lender must first be applied to the debt and credited to the amount in default. Thus, the rents collected apply to reinstate the debt, except when the lender complies with the owner's demand to reimburse him for reasonable costs. [CC §2938(c)]

However, failure of the lender to apply rents to the debt will not:

- result in a loss of the lender's security interest;
- render the debt unenforceable; or

- constitute as an action which would bar a foreclosure under the one-action rule. [CC §2938(c)]

Editor's note — No statutory sanctions exist to penalize a lender who does not follow the accounting rules.

Priority to rents between lienholders

Now consider property encumbered by a first and second trust deed. Both trust deeds contain an assignment of rents provision.

On a default in a payment, the junior lender promptly enforces its assignment of rents provision by making demands for the rents on both the tenants and the owner.

Later, the senior lender enforces its assignment of rents provision by making its demand for the rents on both the tenants and the owner.

The senior lender then claims the junior lender must pay him all rents collected by the junior lender after the owner defaulted on the first trust deed, even though the senior lender did not commence enforcement by notice of his right to the rents until after enforcement by the junior lender.

The junior lender claims the senior lender may only collect the rents which were paid after the senior lender made a demand on the tenants or the owner.

Is the senior lender entitled to all the rents from the time of the default on the first trust deed?

No! The junior lender serving notices under his assignment of rents provision is entitled to collect the rents **until** the senior lender enforces its right to collect the rents by serving notice.

All rents collected by the junior lender prior to the time the senior lender enforces its assignment of rents provision are uncollectible by the senior lender as a source of funds to cure the default on its loan. [CC §2938(h)]

When the junior lender who has enforced his assignment of rents provision receives notice of the senior's enforcement, the junior lender must then:

- **cease collecting** the rents; and

- **send a notice** to the tenants canceling his demand for rents. [CC §2938(h); see **first tuesday** Form 458]

The junior lender's failure to send the cancellation notice will not result in any penalties. However, the junior lender will be liable to the senior lender for any rents received by the junior lender and not forwarded to the senior lender after the senior lender enforces its assignment of rents clause.

Receiving rents after notice

If an owner or a junior lender receives rents after a notice of demand for rents from a senior lender has been served on the owner or tenant, the senior lender serving notice is entitled to the rents collected following notice.

To recover rents improperly received and withheld by the owner or junior lender, the senior lender serving notice has a right to bring an action against the owner or junior lender.

The senior lender's action to recover the rents collected by the owner or junior lender after the lender demands the rents is not a violation of the **one-action rule**. Again, the dispute over rents is unrelated to the foreclosure of the trust deed lien on the real estate, except for the amount of the debt remaining unpaid (which will require an **underbid** at a foreclosure sale to compensate for the net rent collected).

Further, if a dispute arises between the senior lender and another party claiming an interest in the rents — such as in bankruptcy — the lender has a continuously perfected security interest in those cash proceeds from rents which remain identifiable in the hands of the owner (or the court).

To remain identifiable, the cash proceeds must be in a segregated account, or traceable if the rent has been commingled with the owner's or junior lender's other accounts.

Owner files a bankruptcy petition

If an owner files for bankruptcy before his lender enforces the assignment of rents provision, the lender retains a security interest in the post-petition rents collected by the owner or bankruptcy trustee since they are considered *cash collateral*. [11 United States Code §363(a)]

Cash collateral can be used by the owner in bankruptcy in limited circumstances, and only then with the consent of the lender holding a security interest in the rents. [11 USC §363(c)(2)]

Before the statutory scheme for assignment of rents provisions was effective 01/01/1997, conflicting bankruptcy decisions hinged on whether the lender who enforced the assignment of rents provision after the bankruptcy petition was filed was entitled to control any pre-petition rents collected by the owner.

One court held the lender who enforced the assignment of rents provision after the bankruptcy petition was filed was entitled to, as cash collateral, the pre-petition rents paid, even though the lender did not enforce the assignment clause until after the filing. [**In re Scottsdale Medical Pavilion** (9th Cir. BAP 1993) 159 BR 295]

Another court held the lender only had a security interest in unpaid rents when the enforcement occurred after the petition was filed. Thus, the lender could not collect rents paid after the default and before the lender enforced the assignment of rents clause. [**In re Goco Realty Fund I** (1993) 151 BR 241]

California statutes cleared up the confusion created by these conflicting cases.

The *Goco Realty Fund I* case is now the codified rule for the enforcement of post-1997 assignment of rents provisions.

Under the current statutory assignment of rents scheme when no bankruptcy protection has been sought by the property owner, the lender is only entitled to rents which are paid **after the lender enforces** the assignment of rents provision, regardless of whether the rents accrued or became due and unpaid before enforcement.

However, when the owner files a bankruptcy petition, cash collateral includes those rents which were due pre-petition when the rents were received:

- after the petition for bankruptcy was filed; and

- after the assignment of rents provision was enforced through a demand for rents by the lender.

Chapter 18 Beneficiary statements and payoff demands

This chapter addresses requests made on the holder of a trust deed note for a report on the current status of the secured debt or a statement of the amounts due for a payoff and reconveyance of the trust deed.

Confirming loan conditions

A *beneficiary statement* is a written disclosure made by a lender or other creditor regarding the condition of a debt owed them, usually evidenced by a note, that is secured by a trust deed lien on real estate. [See Form 415 accompanying this chapter]

A complete **beneficiary statement** includes information and data regarding:

- the amount of the *unpaid balance*;
- the *interest rate* of the loan;
- the total of all *overdue payments* of principal and/or interest;
- the amounts of any *periodic payments*;
- the *due date* on the loan;
- the date to which *real estate taxes* and special assessments have been paid, if known;
- the amount of *hazard insurance* and its term and premium, if known;
- any *impound* balance reserve for the payment of taxes and insurance;
- the amount of any *additional charges* incurred by the beneficiary that have become part of the trust deed lien; and
- whether the trust deed debt can be *assumed* by a new owner (which was added following federal deregulation of lenders beginning 1982). [Calif. Civil Code §2943(a)(2)]

On adjustable rate mortgage (ARM) notes, the beneficiary statement must list the **note rate** as variable, and reference and attach a copy of the note containing the interest rate formula.

Formulas for ARM adjustments and payment options vary extensively from note to note. Thus, the seller or buyer relying on the beneficiary statement for an ARM needs greater detail than the current interest rate and payment amount. Thus, the lender must **attach a copy** of the ARM note to the beneficiary statement for full disclosure.

Lender response time to a request

Any *entitled person* may request, in writing, a beneficiary statement.

An **entitled person** includes:

- the *original borrower* on the note and trust deed;
- the *successor-in-interest* (new owner) to the original borrower; or
- an *authorized agent* of either, such as a real estate broker, attorney or escrow agent. [CC §2943(a)(4)]

The lender must, within 21 days of the receipt of the written request by an entitled person, prepare and deliver a beneficiary statement. [CC §§2943(b)(1), 2943(e)(6)]

The lender's intentional failure without legal excuse to send the statement within 21 days of receipt of request results in a $300 forfeiture by the lender to the person making the request. Also, the lender is liable for all damages resulting from its intentional failure to comply. [CC §2943(e)(4)]

However, the lender's failure to timely deliver the statement must be proven to be an intentional failure, a difficult task.

*Editor's note — Previous to deregulation, mere administrative failure to send the beneficiary statement within the 21-day period resulted in an automatic forfeiture of $300 by the lender. [**Anderson** v. **Heart Federal Savings** (1989) 208 CA3d 202]*

The request for a beneficiary statement may be made by an **entitled person** before or within two months after a Notice of Default (NOD) is recorded. [CC §2943(b)(2)]

The lender may charge no more than $30 for each beneficiary statement, with the exception of loans insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA). Occasionally, the trust deed states a lesser amount that controls the beneficiary statement charge. [CC §2943(e)(6)]

Payoff demand

A *payoff demand statement* is a written demand, made by a lender, for the total dollar amount required on the date of preparation to pay off the loan as a requisite for recording a reconveyance of the property from the trust deed lien. [See **first tuesday** Form 429-2]

The **payoff demand statement** includes information and formulas to calculate the total payoff amount due after the date the demand is issued to account for and pay interest accruing on a per diem basis up to the date paid. The statement is valid for up to 30 days unless the loan terms change, such as may occur on loans with adjustable interest and payments. [CC §2943(a)(5)]

The payoff demand, as with the beneficiary statement, is required to be delivered within **21 days of receipt** of a written request from an entitled person. Additionally, and similar to the beneficiary statement, the charge for the service of preparing and delivering a payoff demand is limited to $30, unless the loan is insured by the FHA or VA. [CC §§2943(c), 2943(e)(6)]

As with the beneficiary statement, the lender's intentional failure, without legal excuse, to timely reply results in the forfeiture of $300 and liability for any resulting money damages. [CC §2943(e)(4)]

BENEFICIARY STATEMENT

DATE:_____________, 20______, at ____, California.
TO: ____
(Name and address of party requesting statement)
____

Loan No.____
We are the holder(s) of a promissory note for $_______________, dated __________________,
made by ____,
and secured by a Trust Deed recorded on __________________, as Instrument No._______________,
in ____ County, California,
as a lien on property referred to as ____
____.

1. Present principal balance . . . . $_______________
 1.1 Additional charges, costs or expenses advanced by Lender under its lien . . . . $_______________
2. Balance in impound/escrow accounts . . . . $_______________
3. Rate of interest:
 3.1 Annual fixed rate of interest is ______%
 3.2 Present note rate of interest adjustable per the note is ______%
 ☐ Attached is a copy of the note containing adjustment formulas.
4. Interest is paid through _____________, 20______.
5. Taxes and special assessments are paid through _____________, 20______.
 5.1 Taxes and special assessments for the fiscal year of ______ and ______ were . . . . . $_______________
6. Payments are delinquent for the months of __________________________________.
 6.1 Total amount of delinquencies to bring the loan current is . . . . $_______________
 which includes any late charges and foreclosure costs.
7. Monthly payments are due on the ____________________ day of each month.
 7.1 Monthly payment in the present amount of. . . . . $_______________
 Comprised of:
 Principal and interest. . . . . $_______________
 Tax impounds of . . . . $_______________
 Hazard insurance premium impounds . . . . $_______________
 The taxes and premiums are subject to change.
8. The principal balance is all due and payable on _______________, in the amount of $_______________.
9. Hazard insurance is described as follows:
 Amount of Coverage $_______________
 Insurance Company ____
 Policy No. ____
 Expiration Date _____________, 20______
 Policy Term from ____________________ to ____________________
 Amount of Premium $_______________
 Insurance Agent ____
10. ☐ The Trust Deed securing the note contains a due-on-sale clause requiring Lender's consent and approval on any transfer of an interest in the secured real estate.
11. ☐ As requested, a copy of the Trust Deed securing this note is attached.

Date:_____________, 20______
Beneficiary: ____

The request for a statement

Unless an entitled person, such as an owner-in-foreclosure, **specifically requests** a beneficiary statement, a lender need only send a payoff demand statement. [CC §2943(e)(1)]

The request for either statement must be in writing and sent to the lender at the address given in the payment notice or payment book. [CC §2943(e)(5)]

Before delivering the beneficiary statement or payoff demand, the lender may require proof the request is being made by an entitled person, such as evidence of ownership or authority as an agent of the owner. The written request by escrow should be accompanied by the escrow's written authorization from the owner to order out a beneficiary statement. [CC §2943(e)(3)]

If a request for either a beneficiary statement or a payoff demand includes a request for a copy of the trust deed, the lender must supply a copy of the document at no extra charge. [CC §2943(e)(2)]

The statutory scheme for beneficiary statements does not require that a payoff demand include delivery of a copy of the note.

The lender may issue either the beneficiary statement or the payoff demand statement to set forth the amounts necessary to pay a loan in full. [CC §2943(d)(1)]

Any **oral amendment** to either statement given by the lender must be followed up by delivery of a written amendment by the next business day. [CC §2943(d)(2)]

In addition to a beneficiary statement or a payoff demand, amended statements can also be relied on to establish payoff amounts. [CC §2943(d)(1)]

An erroneous statement or demand

Any error in the statements from a lender regarding the amount owed on a loan becomes an *unsecured obligation* of the **original borrower** after the close of escrow or completion of the trustee's sale. If the lender amends its loan statement prior to the close of escrow or the trustee's sale, the amount listed in the amended statement is valid and replaces the original amount. [CC §§2943(d)(3)(A), 2943(d)(3)(B)]

For example, an owner funds the payoff of a trust deed note by obtaining refinancing from a new lender. The payoff demand for the existing trust deed note erroneously understates the amount due. The new lender funds the amount stated in the payoff demand and the existing trust deed is reconveyed.

Later, the paid-off lender realizes the mistake in the amount of the payoff and seeks to recover the underpayment from the new lender. The paid-off lender claims the new lender is liable for the unpaid amount since it funded the payoff.

The new lender claims the real estate owner who signed the note is liable for the unpaid amount since the statutory beneficiary's payoff scheme only allows the lender to recover amounts remaining unpaid on reconveyance from the borrower obligated on the note.

Here, the lender issuing an erroneous payoff demand can only recover amounts remaining unpaid from the **original borrower**. The named borrower on the note is the sole source of recovery for amounts understated in the payoff demand. [**Freedom Financial Thrift & Loan** v. **Golden Pacific Bank** (1993) 20 CA4th 1305]

Nonrecourse debt payoff errors

A lender who makes a purchase-assist loan to a buyer of a one-to-four unit residential property he will occupy as his principal residence is barred from obtaining a money judgment for any deficiency in the value of the property to fully payoff the loan on a foreclosure. These loans are **nonrecourse loans**, called *purchase-money obligations*.

Likewise, carryback notes secured only by the property sold are nonrecourse *purchase-money* paper. Further, those who hold a purchase-money note by assignment are also barred from obtaining a deficiency judgment.

The carryback seller or lender who makes a mistake in the amount of a payoff demand or beneficiary statement issued on a *nonrecourse note*, is limited in its recovery to the value of the property at the time of the erroneous payoff demand.

Initially, the amount of the error on payoff becomes an *unsecured purchase-money* obligation of the original borrower. The amount unpaid remains a **nonrecourse debt**. The character of the remaining unpaid debt did not change; it only became unsecured. [CC §2943(d)(3)]

Thus, the lender or carryback seller on a nonrecourse debt is limited in his recovery of the error to the difference between the amount received and the value of the property at the time of the erroneously calculated payoff. [**Ghirardo** v. **Antonioli** (1996) 14 C4th 39]

Recourse debtor payoff error

The amount of an error made in a beneficiary statement or payoff demand for a **recourse debt** also becomes an unsecured obligation. However, recovery on a recourse loan is not limited to the value of the property on the date of the payoff as is the case for a nonrecourse debt. [Calif. Code of Civil Procedure §726(b)]

A lender who demands and is paid an erroneous amount on payoff of a **recourse loan** can proceed directly to a money judgment against the borrower obligated on the note for the uncollected amount, regardless of the value of the security.

Thus, sellers of property encumbered by a recourse loan expose themselves to a continuing liability for trust deed debts they owed as original or assuming borrowers after the property is sold subject to the existing trust deed lien.

A seller originating a recourse loan is considered a *guarantor*, secondarily liable for payment of the loan if the buyer fails to pay, unless the assumption of the loan by the buyer included a significant modification in its terms to which the seller was not a party. [**Braun** v. **Crew** (1920) 183 C 728]

When the buyer later resells the property acquired from the seller by an assumption of a loan, and a mistake is made by the lender in a payoff demand or beneficiary statement on the resale resulting in an underpayment to the lender, then the **seller** who originally borrowed the funds is a guarantor of payments on the original note and is liable for the error.

Thus, a seller who originated or assumed a loan that his buyer is now assuming with the lender may feel compelled to condition the closing of the sale on a **release of liability** from the lender, called a *novation*.

The release of liability eliminates the seller's risk of "original borrower liability" for a potential future error by the lender in payoff demands or beneficiary statements. [CC §1531]

In a **novation**, as with an assumption, the buyer promises to perform the duties of the original borrower. In addition, the lender agreeing to the novation releases the seller from all future liability for the debt. [See Chapter 16]

Chapter 19 — Grant deed as a mortgage

This chapter explains the legally defective nature of a grant deed used to hold title to property when its use is intended to provide security for the repayment of money owed.

Risks in alternative security devices

A parcel of real estate is encumbered by a trust deed securing a loan which is due. The principal balance equals 70% of the property's value. The owner of the real estate does not have sufficient funds to pay off the loan himself.

The owner attempts to refinance the property but is unable to obtain a new conventional loan. Eventually, a private investor is located who advances the funds needed to pay off the loan. The investor wants to be repaid in two years.

As security for repayment of the funds advanced, the owner conveys title to the real estate to the investor by a grant deed. However, the owner retains possession of the property, maintains the improvements and pays all property taxes, insurance premiums and operating expenses.

The owner, on delivery of the grant deed to the private investor, is given a lease and an option to repurchase the property, called a *sale-leaseback* and *option*. The rent installments and a single final payment on exercise of the option equal the amount advanced and the yield sought by the private investor.

Did the grant deed from the owner convey **fee simple ownership** of the property to the investor?

No! The **sale-leaseback** and **option** transaction is not a sale at all, but is merely a **secured loan transaction.** Thus, delivery of a grant deed simply imposed a lien on the owner's interest in the property for the amount of the debt owed to the investor, since:

- the owner remains in possession of the property and pays all property taxes, insurance and operating costs;
- the amount of the purchase price is substantially less than the value of the property; and
- the repurchase option indicates the owner and lender intend the owner to recover title to the property by paying back the amount advanced, plus a fixed yield.

Thus, the grant deed conveying legal title to the lender is *recharacterized as a mortgage* to grant the lender a security interest in the real estate, not an ownership interest allowing for eviction. Here, the grant deed, like a trust deed, does not convey an ownership interest in the real estate; it establishes a lien in favor of the named grantee for recovery of money – limited to foreclosing. [**Orlando** v. **Berns** (1957) 154 CA2d 753]

A mortgage-in-fact on a grant

A grant deed is typically used to transfer the fee ownership of real estate from a seller to a buyer. At first glance, that is what everyone assumes occurs when a grant deed is recorded. The buyer acquires title and possession to the property conveyed, subject only to those encumbrances known to exist or recorded on title to the property. [Calif. Civil Code §1105]

However, a grant deed given by an owner for the sole purpose of securing the future *performance of an obligation* — such as the payment of money — is considered a **mortgage**. Thus, the grant only imposes a lien on the property, not a transfer of ownership or title. [CC §2924]

When a grant deed is given to secure a debt, the seller (grantor) remains the true owner of the property, subject to the security interest granted to the buyer (grantee) who, by the recharacterization of the grant as a mortgage, is merely a secured lender.

Thus, the rights and remedies of the grantor and grantee under the grant deed are those of an owner and a lender, not a seller and a buyer or a landlord and a tenant when repayment of a debt is involved.

A land sales contract is a variation on the grant deed as a mortgage. A grant deed is not used to provide security for money owed. Instead, title is **retained by the seller** as security for the buyer's payment of the purchase price.

The buyer on a land sales contract will not receive a grant deed until all payments on the purchase price have been made. Nonetheless, the buyer becomes the owner of the real estate on execution of the land sales contract and transfer of possession, called *equitable ownership*. The seller's retention of title on his entering into a land sales contract converts his interest in the property from ownership to that of a lien for money owed.

Likewise, CalVet lends money to buyers to purchase real estate when CalVet receives title to the property. As the vested owner of record and lender under a *participation contract*, CalVet has no ownership interest in the property and no duty to perform the obligations of ownership whatsoever; it is a lender with an imperfectly stated lien on title (due to a statutory aberration that has yet to be corrected). [**Cunningham** v. **Superior Court** (1998) 67 CA4th 743]

An owner's grant deed mortgage risks

For an owner, a grant deed given to a lender to secure a debt:

- creates confusion in the county records as to who owns the real estate should the owner later decide to sell or further encumber the property;
- triggers the due-on clause in any existing trust deeds on the real estate;
- triggers inquiry by the county assessor as to the reassessment of the property due to a change of ownership on title; and
- creates a risk the grant deed lender will deed out, further encumber the property, or attempt an eviction on the owner's default.

Transfer of title vs. a security interest

Whether a grant deed conveyance constitutes a mortgage or a **change of ownership** depends on all aspects of the transaction, including:

- whether a substantial difference exists between the price to be paid to repurchase the property under an option and the property's fair market value;
- who assumes the ownership duties of the property; and
- the intentions of the parties as evidenced by written documents, such as purchase agreements, escrow instructions, loan documents, leases and repurchase options.

For example, a real estate investor who receives a grant deed assumes the existing liens and takes possession of the property, collects rents, pays taxes and insurance premiums and maintains the property. Thus, the investor acts as the owner of the property. When the investor assumes the duties of ownership, the grant deed is treated as a true change of ownership, even if a repurchase option is included in favor of the seller. [**Develop-Amatic Engineering** v. **Republic Mortgage Co.** (1970) 12 CA3d 143]

Due-on and reassessment

Under normal circumstances, further encumbering an owner-occupied, single family residence (SFR) with a junior lien does not trigger a senior lender's due-on clause. [12 Code of Federal Regulations §591.5(b)(1)(i); see Chapter 21]

However, a grant deed used as security for a loan is not only a further encumbrance, but a purported transfer of legal title. The grant deed can lead to due-on enforcement, since the **due-on clause** in an existing trust deed is triggered by the conveyance of any interest in real estate — including a lease-option, a lease with a term over three years or a land sales contract. [12 CFR §591.2(b)]

While a junior trust deed will not lead to the senior lender calling the loan on an owner-occupied SFR, a grant deed used to document the same loan transaction will trigger the due-on clause unless it can be shown to the lender calling the loan to be a secured transaction.

A further risk exists regarding **reassessment** by the county assessor. A grant deed indicates a change of ownership. However, the transfer of a security interest in real estate, even by grant deed, is not considered a change of ownership for property tax purposes. [Calif. Revenue and Taxation Code §62(c)(1)]

Thus, to avoid reassessment, the true owner must demonstrate to the assessor (or the assessment appeals board) that the grant deed is only a lien on the property, and, by the evidence, was not intended to transfer any rights of ownership.

Subsequent buyers

A borrower who agrees to use a grant deed to secure repayment of a loan also faces the possibility the investor might deed the property to others, become incapacitated or die. Whether the conveyance of the property by the lender to another party constitutes a valid sale depends on whether the buyer has notice of the borrower's ownership interest in the property.

For example, if an owner executes a grant deed mortgage and remains in possession of the real estate acting as the owner of the property, the third party buyer is on notice to inquire into the rights of the owner. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]

Also, the buyer may have constructive notice of the owner's rights based on a recorded document, such as a lis pendens or any other document relating to the loan transaction for which the grant deed is security.

If the buyer has notice of the owner's rights, the buyer is not considered a bona fide purchaser (BFP), and does not acquire any greater title or interest in the property than was held by the lender who held the grant deed as security.

However, if the buyer acquires the property without receiving actual or constructive notice of the owner's rights — i.e., without being aware the grant deed to the lender functions as a mortgage — the buyer acquires clear title as a BFP. [**Carpenter** v. **Lewis** (1897) 119 C 18; CC §2950]

The owner cannot recover the property from a BFP. His only remedy would be to recover his lost equity in the property from the lender — the loss being the difference between the price received by the lender (or the property's fair market value, if greater) and the debts encumbering the property, including the debt owed to the lender. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

A lender's grant deed mortgage risks

The private lender who holds a grant deed as the device for securing recovery of his funds has concerns which include:

- possible **usury claims** by the owner if the amount of the installments and repurchase price exceeds the amount of the funds advanced by more than the allowable average annual yield;

- the need to **foreclose judicially** to exhaust the *right of redemption* should the owner default, since the grant deed, when recharacterized as a security device, does not contain a power-of-sale provision, as does a trust deed;

- compliance with **equity purchase (EP) laws** if the property is an owner-occupied, one-to-four unit residential property in foreclosure; and

- **tax reporting** as an owner or lender.

Thus, in any loan transaction, a simple note and trust deed is a far better choice of documentation to express and establish the rights and obligations of both the lender and the borrower than the use of a grant deed as a mortgage.

Usury

A private lender using a grant deed as a security device may be charging a usurious rate of interest. [Orlando, *supra*]

When a grant deed with a leaseback and repurchase option is used to secure a loan, the interest charged on the loan is calculated as the difference between:

- the amount of the funds advanced by the lender, which is the loan amount; and

- the repurchase price to be paid by the borrower and rent payments.

Since a sale-leaseback transaction is considered a loan, **usury laws** limit the amount of the repurchase price (repayment of the loan plus a yield calculated as interest) the lender can charge the borrower. [See Chapter 41]

Equity purchase rules

Equity purchase laws protect owners who enter into sales-leaseback transactions on owner-occupied, one-to-four unit residential property **in foreclosure** in which a grant deed conveys title to the property as security for a loan. [Segura, *supra*]

If the equity purchase (EP) agreement grants the seller an **option to repurchase** the property, the transaction is considered a loan, and the conveyance of the property to the equity purchaser is a mortgage which grants only a security interest. [See Chapter 20]

Broker's duty to advise

A broker advising the use of a grant deed as a mortgage is not liable for malpractice, since the lender has received security for the loan. [**Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25]

However, the broker giving such advice is not at all serving the best interests of his client. Given the heinous disadvantages for both the lender and the borrower when a grant deed is used as a mortgage, the conventional note and trust deed is always a better form for documenting a real estate loan transaction.

Chapter 20 Equity purchase: sale-leaseback, no option

This chapter digests the legal and tax consequences which arise due to the recharacterization of a sale-leaseback arrangement as a loan transaction when the leaseback is coupled with a repurchase option.

The home equity sales scheme

An *equity purchase* (EP) transaction is the sale or other transfer of title by an owner-occupant of a one-to-four unit residential property when:

- the property is in foreclosure under a recorded Notice of Default (NOD which has not been rescinded; and
- title to the property is acquired by either a buyer for rental, investment or dealer purposes, or a person advancing funds which are to be prepaid, called an *EP investor*.

Conversely, an EP transaction does not occur and the EP rules do not apply if the buyer acquires the property to occupy it as his *personal residence* or a lender originates a trust deed loan. The EP codes distinguish *prinicpal residence* of the seller from the buyer's acquisition of a property to be used by the buyer as his **personal residence**. Thus a buyer's acquisition of a second home or vacation home for "personal use" is legislatively intended to be exempt from the EP laws.

Equity purchase statutes apply to all investors regardless of the number of EP transactions the investor completes. The investor need not be **in the business** of purchasing or advancing funds on homes in foreclosure for the EP statutes to apply. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

The investor and all brokers involved must use a written agreement configured and containing notices as required by EP law. Failure to use the correct forms subjects the investor and the brokers to liability for all the losses incurred by the seller-in-foreclosure, plus very severe penalties. [Segura, *supra*]

After entering into an EP sale, a **seller-in-foreclosure** has a statutory five-business day *right to cancel* the sales agreement he has entered into with an investor. Cancellation avoids the sale entirely.

The seller-in-foreclosure's five-business day **right to cancel** does not commence until proper notice of the cancellation period is given to the seller. Thus, the notice is contained in the purchase agreement forms designed for equity purchase transactions, to trigger the running of the cancellation period from the moment the seller accepts an offer. [Calif. Civil Code §§1695.4, 1695.5]

Further, and until expiration of the seller-in-foreclosure's right to cancel the transaction, the **EP investor** may not:

- **accept a conveyance** from the seller of any interest in the property;
- **record a conveyance** of the residence with the county recorder;
- **transfer an interest** in the property to a third party;

- **encumber any interest** in the residence; or

- **hand the seller** a "good faith" deposit or other consideration. [CC §1695.6]

In negotiations with the seller-in-foreclosure, the **EP investor** may not misrepresent:

- the **value of the property** in foreclosure;

- the **net sales proceeds** the seller will receive on closing escrow;

- the **terms of the purchase agreement** or any other document the EP investor uses to induce the seller to sign; or

- the **rights of the seller** in the EP transaction. [CC §1695.6(d)]

Cancellation of the purchase agreement by the seller-in-foreclosure is **effective on delivery** of the signed written notice of cancellation to the EP investor's address in the purchase agreement.

When the cancellation period expires for lack of cancellation, the purchase agreement becomes enforceable and escrow can be closed — unless other conditions exist which must first be eliminated.

After escrow closes, and while the EP investor remains the owner, his title is subject to the seller-in-foreclosure's **right of rescission** for two years. The rescission must be based on some *unconscionable conduct* of the EP investor. The seller's two-year right to *rescind and recover* the property from the EP investor cannot be waived by the seller. [CC §§1695.10, 1965.14]

An EP investor who violates the five-day cancellation period or takes *unconscionable advantage* of the seller-in-foreclosure will be subject to imprisonment and a fine no greater than $25,000 or both for each violation. [CC §1695.8]

Also, any broker representing an EP investor as the **buyer's agent** must provide the seller-in-foreclosure with proof he is currently licensed, together with a written affidavit stating under **penalty of perjury** that the broker is a licensed real estate broker. [CC §1695.17(a); see **first tuesday** Form 156 §14.1]

At the time of this writing, brokers representing EP investors are not required to be bonded by any surety insurer: The courts threw out the original bonding requirements. [**Schweitzer** v. **Westminster Investments** (2007) 157 CA4th 1195]

A mortgage or tenancy on breach?

A homeowner defaults on loan payments secured by a trust deed on his home. The lender begins foreclosure proceedings by recording a Notice of Default (NOD).

The NOD recording is picked up by a foreclosure reporting service. The service's subscribers are then advised of the NOD. An equity purchase (EP) investor tracking NOD recordings contacts the homeowner, intending to investigate the property for suitability and acquisition.

An offer to purchase the residence is prepared and submitted to the homeowner on an EP agreement form as mandated by state law.

However, the homeowner advises the EP investor he really wants to retain possession of the residence and **buy back** the ownership when his personal finances pick up.

As an alternative to the EP investor's offer, the homeowner proposes a **sale/lease-option** arrangement in which:

- the investor acquires title to the property by investing only the funds needed by the owner to cure the delinquent loan payments and property taxes, and pay the annual property insurance premium and foreclosure costs;

- the seller-in-foreclosure would remain in possession under a lease with sufficient rental payments to cover the investor's costs of ownership; and

- the owner would be given an *option to repurchase* the residence at a price to include a profit for the investor.

The EP investor refuses to go along with the owner's proposal to be granted an option to repurchase the property. The investor claims the grant of a purchase option to the owner would:

- transform the investor's intended purchase into a loan transaction; and

- bar the investor from conveying title or encumbering the property at any time without the owner's further consent; and

- deprive the investor of the investment and tax benefits of owning real estate.

As a result, the investor and the owner reach a compromise. They enter into an EP agreement that provides the owner with a six-month holdover tenancy — no repurchase option included.

Has the EP investor correctly represented the mortgage and tax consequences of holding title subject to a repurchase option as a loan, called a *mortgage-in-fact*?

Yes! A sale-leaseback and purchase option arrangement is a *mortgage*. Thus, the EP investor would have made a loan, not a purchase of ownership of the property. When an owner occupying a one-to-four unit residential property as his principal residence conveys title in exchange for money to cure delinquencies and the right to retain possession with an **option to repurchase** the property, a loan has been negotiated, not a sale.

The financial arrangement of the lease-option sale contains all the elements of a loan: a yield (interest and principal paid as rent) and a due date (final/balloon payment of principal on exercise of option) as a condition for returning (reconveying) title. Thus, the investor becomes a lender holding title as security for repayment of a debt, not a buyer receiving the possessory rights and economic risks and benefits of an owner. [Calif. Civil Code §1695.12]

As a lender, the EP investor is not able to take depreciation or other **tax benefits** available to an owner of rental property. [**Haggard** v. **Commissioner** (9th Cir. 1956) 241 F2d 288]

An investor who takes title to property while allowing the owner the right to remain in the property and the right to repurchase the property under an **option to buy** does not own the property. The grant deed the investor receives merely conveys title as security for repayment of a debt, a *mortgage-in-fact*. Despite any additional set of agreements or circumstances (even using EP agreements and fully com-

plying with right to cancel notices), the investor taking title must not give the owner-in-foreclosure an option to recover title to the property. However, the investor taking title who does not grant an option to buy to the owner must later obtain **written permission** from the owner before the investor may:

- encumber the property; or
- grant any interest in the property to another person. [CC §1695.6(e)]

Thus, when the owner defaults on the lease and vacates the property, the investor is left with naked title, unable to refinance the property, convey title to another person or create a leasehold interest under a rental or lease agreement with a tenant—without the owner's prior approval. [CC §1695.12]

Equity loan during foreclosure

Consider an owner whose home is in foreclosure due to a default under a trust deed lien on his home. He asks a friend to make him a loan.

The friend advances all funds necessary to cure the default under the trust deed and take the property out of foreclosure, called *reinstatement*.

As security for repayment of the friend's advance of funds, the homeowner conveys title to the friend. As part of the arrangements, the owner is to remain in possession under a lease agreement and is granted an option to recover title to the residence on a final payoff to the friend.

Later, the owner defaults on the rent and voluntarily vacates. The friend locates a buyer, enters into a purchase agreement and conveys title to the buyer.

The owner now out of possession seeks to recover the value of his lost equity from his (former) friend. The owner claims an investor who takes title and grants an option to the owner to repurchase the property must first obtain the owner's consent before the investor may convey any interest in the property to another since the transaction was entered into while the home was in foreclosure.

The friend claims EP law does not apply to him since he is not in the business of lending money, much less buying homes in foreclosure.

However, EP law applies to all persons whose conduct constitutes that of an EP investor, regardless of the number of EP transactions the person completes. The investor conveyed title to the property without first obtaining written consent from the owner (even though the investor held title), in violation of equity purchase law. [CC §1695.6]

The EP investor's failure to obtain the owner's written permission prior to conveyance on the property's resale imposes liability on the EP investor for breach of the owner's (redemption) rights when a loan is involved. The money losses collectible by the owner are based on the value of the property at the time the EP investor first transferred the property without the owner's consent. [Segura, *supra*]

Additionally, consider an owner-in-foreclosure who is in bankruptcy and conveys his property to an investor at a price lower than its market value. The transaction is structured as a grant deed conveyance to the investor with a leaseback agreement and the grant of a repurchase option to the owner. Specially printed equity purchase forms with right of rescission notices to the owner-in-foreclosure were not entered into by the owner and the investor.

The transaction is approved as a sale of the property by a trustee acting on behalf of the bankruptcy court.

The owner-in-foreclosure is not able to repurchase the property on expiration of the repurchase option. A notice to vacate is served by the owner.

The owner now seeks to quiet title to the property in his name, claiming the sale-leaseback agreement violated of the Home Equity Sales Contract Act (HESCA) EP law since the investor, knowing the home was in foreclosure, acquired title to the property without complying with the notice requirements of the EP law.

The investor claims the sale was authorized by the equivalent of a court order, and thus exempt from equity purchase laws, since the sale was approved by a bankruptcy trustee acting on behalf of the court. [CC §1695.1(a)(5)]

Here, the sale by the owner-in-foreclosure to the investor was subject to EP law since the exemption for court-ordered sales does not apply to sales of property approved by a mere bankruptcy trustee. [**Spencer** v. **Marshall** (2008) 168 CA4th 783]

Continued occupancy by the owner-in-foreclosure

Any leaseback agreement negotiated with a n owner-in-foreclosure must be reduced to a written addendum as part of the EP agreement, or by amendment prior to funding by the EP investor and conveyance of title by the seller. [CC §1695.3(f)]

The owner-in-foreclosure and EP investor structuring a transaction occasionally consider one of several occupancy arrangements for the owner:

- a sale-leaseback, typically a *holdover tenancy* for a fixed time period at which point the owner must vacate [See **first tuesday** Form 272];

- a sale-leaseback with an option to purchase as an addendum (which is a mortgage-in-fact), sometimes called a *reverse lease-option* [See **first tuesday** Forms 161 and 550]; or

- an unexecuted purchase agreement coupled with a lease-option agreement with the seller, a variation on the prior arrangement but does not call for immediate conveyance. [See Form 163 in Chapter 35]

In a straightforward lease arrangement, a security deposit and the first month's rent are payable to the EP investor at the closing of an EP sale since the seller will holdover for a specified time period. The seller usually prepays rent and a security deposit through escrow from his net sales proceeds. So long as the EP laws calling for the use of special Equity Purchase agreements and right-of-rescission notices are complied with, the sale-leaseback arrangement does not violate the EP laws. It is the repurchase option given under any circumstances which sets the investor up for a future violation of the EP law.

Sale-leaseback recharacterized

Inherent in an EP sale-leaseback and option to repurchase the property is the risk the loan transaction will be misinterpreted by the local assessor, the existing lender or the Internal Revenue Service (IRS).

Reassessment of the property occurs on execution of a sale-leaseback. [**Pacific Southwest Realty Company** v. **County of Los Angeles** (1991) 1 C4th 155]

However, if the "two-step" financing scheme is brought to the attention of the assessor, a sale-leaseback intertwined with an option to repurchase is correctly recharacterized by all agencies (and the seller) as a single **financing arrangement**, rather than two consecutive sale and repurchase transactions. Thus, no change of ownership occurs, even though the vesting of title is altered, and no reassessment takes place. [Calif. Revenue & Taxation Code §62(c)]

Existing lenders view a sale-leaseback, with or without a repurchase option, as an opportunity to **call or recast** a loan under their *due-on clause* — should they become aware of the facts. An EP investor should consider including a contingency in the EP agreement calling for a *due-on waiver* to be negotiated with the existing lender prior to closing. [See Chapter 28]

An existing lender usually will not demand a modification or call its loan unless the current market rates are so high as to allow the lender to increase its portfolio yield through points or an increased interest rate, either by loan modification or a payoff and reinvestment in a new loan.

Federal tax consequences

The **IRS** also treats sale-leasebacks as loan transactions, not a sale or a purchase, when the seller remains in possession and is given an option to repurchase title to the property. Taxwise, the sale-leaseback is a financing arrangement when:

- rental payments under a long-term lease equal an amortization of the fair market value over the term of the lease when title is to be reconveyed to the seller/tenant; or
- the final/balloon payment required to exercise a repurchase option equals principal and accrued interest that would be financially similar to the due-date payoff under a note and trust deed. [**M & W Gear Co**. v. **Commissioner** (7th Cir. 1971) 446 F2d 841]

The EP investor's tax consequences on **recharacterization** of a sale-leaseback and purchase option as a financing arrangement include:

- denial of any depreciation deductions;
- imputing of interest income reportable at 110% of the applicable federal rate (AFR) [Internal Revenue Code §1274(e)];
- reporting of would-be rental income as investment/portfolio category interest income on a loan; and
- denial of any rental operating expenses (impound for taxes and insurance premiums belonging to the seller), since the transaction is a loan.

For the EP investor to receive the tax benefits of owning real estate, he must limit the leaseback to a periodic tenancy (month-to-month) or a tenancy with a fixed date at which time the tenant is to vacate the premises (lease agreement)—no repurchase option allowed either way.

No repurchase options granted

An EP investor structuring a sale-leaseback, which does not include a repurchase option, eliminates the risk the transaction will be recharacterized as a financing arrangement if:

- the seller-in-foreclosure is given the lease in full or part exchange for his equity (or for his payment of rent); or
- the rent charged is the current fair market rate; and
- the leaseback agreement sets a "fixed" time period for the lease to terminate and possession to be transferred to the EP investor. [**Camp** v. **Matich** (1948) 87 CA2d 660]

If the seller-in-foreclosure is not given a repurchase option and remains in possession of the property after the lease expires, the EP investor can begin an unlawful detainer (UD) action without prior notice to the seller to vacate, and proceed to have the prior owner evicted. [**Ryland** v. **Appelbaum** (1924) 70 CA 268]

As in any lease, the leaseback agreement should provide for payment of increased rent if the seller-in-foreclosure does not vacate upon either the expiration of the lease or a notice to vacate used to terminate the tenancy under a month-to-month rental agreement. A reminder: The seller-in-foreclosure has defaulted on home payments. Thus, he is a serious adverse credit risk as a tenant for the EP investor.

Chapter 21 Due-on-sale regulations

This chapter clarifies the events which trigger a lender's due-on clause and analyzes the adverse socio-economic effects of due-on regulations on the real estate resale and equity loan markets.

Rising rates bring lender interference

During the good times of upward sales volume, expanding mortgage origination and increasing absorption rates for available rented space, the marketplace functions at full throttle—a virtuous cycle. Social benefits of lending abound.

Every sales activity feeds on every other sales activity. No one seems to care about the excuses and inherent inefficiencies buried in the process.

Responsibility for all this frenzy lies solely with the gatekeepers to entry into real estate ownership, and relocation—the brokers and lenders. All other parties to a real estate transaction, being merely affiliated, provide closing services once the broker has located a buyer and the lender qualifies that buyer (and the property) for a purchase-assist loan. Singularly, these two events by these two guardians of real estate are the nucleus of a sale, and all else follows as support services.

During the good times of rising prosperity for all, buyers will put up with the onerous threshold of entry procedures maintained by these gatekeepers. In the rush to do deals, all the numerous steps to ownership seem to be justified, or are simply overlooked as necessary tedium to get in on the act.

However, when, as always it must, the cause of a recession - short-term interest rates rise to outrun inflation - dampens enthusiasm (1989, 2000, 2005). The restrictions on entry posted by the brokers and lenders, burdensome in the first place, are actually tightened to discourage the able and ready buyers who then become unwilling to put up with both the hassles of entry or relocating and the regime of higher rates and increased credit standards: A vicious cycle which takes years to unwind after it bottoms.

Enter *due-on-sale* restrictions (and efforts to get around brokers). As a result, socio-economics decline.

One of the burdens on the mobility of title necessary to sell real estate which restricts the ease with which a buyer and seller can make a deal is the *due-on clause* you will find buried within the copy of all trust deeds held by lenders. During boom years, buyers can easily qualify for a new loans and sellers are relatively unconcerned about the size of the prepayment penalty on their mortgages that the due-on clause is not an issue.

However, as the boom turns to bust and buyers want to buy property, the most effective financing arrangement is to take over the seller's loan. However, the lender as the gatekeeper generally says no to any type of loan takeover or assumption—"I want my repayment penalty and I can re-lend the money at higher current rates." Thus, what was not a burden and not a factor inhibiting deals made during the boom becomes a noose about the seller's neck tying him to his property without a way through the MLS to get out from under the loan—or the property.

Attempts to circumvent the restraint

A parcel of real estate which is listed for sale is security for a loan under a first trust deed lien containing a **due-on clause**. The listing agent locates a buyer for the property.

The purchase agreement negotiated by the listing agent calls for closing to be contingent on the buyer entering into an *assumption agreement* with the first trust deed lender allowing the buyer to take over the loan on the property. The seller will carry back a note secured by a second trust deed for the balance of the purchase price after the buyer's down payment.

The buyer is advised the senior lender may:

- refuse to allow the loan to be assumed, forcing the buyer to arrange new financing suitable to acquire the property; or

- require a modification of the loan at a less favorable rate than the note rate on the loan and demand a large assumption fee.

Before contacting the lender to process an assumption, the buyer suggests the sale of the property be structured as a lease-option in an attempt to avoid due-on enforcement by the lender.

The buyer and seller discuss entering into a two-year lease agreement with an option to extend the lease for two years at an increased monthly payment. The buyer will be granted an option to purchase for the life of the lease.

The down payment will be restated as *option money*. The **option money** will apply to the purchase price of the property, as will a portion of each monthly payment, called *rent*.

Meanwhile, the seller will continue making payments on the trust deed loan. When the buyer exercises his purchase option, the loan will be assumed or paid off and the buyer will become the record owner of the property.

Does the lease-option sale avoid due-on enforcement by the lender?

No! Any lease agreement which contains an option to purchase triggers due-on enforcement by the lender on discovery. [12 Code of Federal Regulations §591.2(b)]

Lender interference authorized by federal mortgage law

Generally, all lenders and carryback sellers are allowed to enforce their due-on sale clauses in trust deeds on nearly all transfers of an interest in any type of real estate. [12 United States Code §1701j-3, Garn-St. Germain Depository Institutions Act of 1982 (Garn)]

Thus, federal mortgage law deprives Californians (and residents of numerous other states) of their state law right to convey real estate subject to trust deed liens without the lender interfering with the transfer of ownership, unless the lender can show the buyer lacks creditworthiness, a federal legislative process called *pre-emption*.

The occurrence of an event which triggers due-on enforcement automatically allows the lender to:

- **call the loan**, demanding the full amount remaining due be paid immediately, also known as *acceleration*; or

- **recast the loan**, requiring a modification of the loan's terms as a condition for the lender's consent to a transfer, called a *waiver by consent*.

The *Garn Act* encourages lenders to allow buyers to assume real estate loans at existing rates, but provides lenders no incentives for doing so. The congressional intent in passing the *Garn Act* was to **preempt state law restrictions** of due-on enforcement, allowing the lenders to increase their profits, a process called *deregulation*. However, the enforcement of the due-on clause by lenders was not intended to occur at the expense of permitting **excessive lender interference** with real estate transactions, whether they are sales, leases or further encumbrances. [12 USC §1701j-3(b)(3)]

Yet, when the Federal Home Loan Bank Board (now the Office of Thrift Supervision (OTS)) issued **due-on regulations** to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights.

The OTS regulations allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few family-related, owner-occupied single family residence exceptions. No encouragement or guidelines were established in the regulations as proffered by congress for lenders to consent to loan assumptions or to limit interference in commonplace transactions.

Since lenders often disregard the law in their trust deed lending and enforcement practices, it is hard to imagine why they would comply with a mere congressional request, a "moral risk" created by congressional reaction to lender misconduct. In the absence of any regulatory obligation, lenders use their due-on clauses to maximize their financial advantage over owners by calling or recasting loans on the sale of the secured property. Thus, they increase their portfolio yield in a rising interest rate market by adjusting the rate of interest.

Economic recessions and recoveries

In times of stable or falling interest rates, lenders, when requested, usually permit assumptions of loans at the existing note rate, unless a prepayment penalty clause exists. Lenders have no financial incentive to recast loans, or call and re-lend the funds at a lower rate when interest rates are dropping in the marketplace.

However, in times of steadily rising rates, lenders seize any event triggering the due-on clause as an opportunity to increase the interest yield on their portfolio. Once the due-on clause is triggered, the lender requires the loan be recast at current market rates as a condition for allowing an assumption, lease or further encumbrance of the property by the owner.

Thus, real estate ownership encumbered by due-on trust deeds becomes increasingly difficult to transfer as interest rates rise, contributing to the "imprisoning" of an owner in his own home as he is unable to relocate. Lender due-on interference is virtually guaranteed since the interference results in an increase in the lender's portfolio yield which permits them to remain solvent, if not the owner.

However, the *inhibiting effect* on buyers during recessions when buyers are required to assume existing financing at higher interest rates has an adverse economic effect on real estate sales, as well as the availability of private junior financing and long-term leasing. Ultimately, as rates and lender interference rise, many buyers, equity lenders and long-term tenants are driven out of the market, which further depresses property values.

"It has recently come to our attention . . ."

Trust deed called or recast at lender's option

Events triggering the due-on clause

Sale:

- transfer of legal title (grant or quitclaim deed);
- land sales contract or holding escrow;
- court-ordered conveyance; or
- death.

Lease:

- lease for more than three years; or
- lease with an option to buy.

Further encumbrance:

- creation or refinance of a junior lien; or
- foreclosure by junior lienholder.

Transfers not triggering due-on enforcement

(owner-occupied, four-or-less residential)

- creation of junior lien where owner continues to occupy;
- transfer to spouse or child who occupies;
- transfer into inter vivos trust (owner obtains lender's consent and continues to occupy);
- death of a joint tenant; or
- transfer on death to a relative who occupies.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below the remaining balance on encumbrances, leaving owners with no (read: negative) equity in the property. It is a vicious cycle which evolves into a dramatic increase in loan foreclosures, the antithesis of the profit motive for automatic lender enforcement of the due-on clause.

Due-on interference was an obscure issue during the 25-year period (1982 through 2007) after *Garn* became law. During this period, fixed mortgage rates declined from 15% to 5% as managed by the Federal Reserve Bank, the earnings of buyers increased (but not as fast as inflation was rising), inflation dropped, and mortgage money became more plentiful. All that was reversed commencing in 2007.

Due-on-sale

Due-on clauses are most commonly known as *due-on-sale* clauses. However, "due-on clause" is a more accurate term. A sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the lender's due-on clause is a sale of property which is subject to the lender's trust deed lien.

The due-on clause is triggered not only by a transfer using and recording a standard grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, whether or not it is recorded. Examples include a land sales contract, lease-option sale, or other alternative carryback devices, such as an all-inclusive trust deed (AITD).

For example, a land sales contract does not involve a conveyance of real estate to the buyer by grant deed. The seller on a contract (for deed) retains title as security for the carryback debt owed by the buyer rather than use a trust deed lien to evidence his security interest. However, the buyer becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession is transferred, triggering the due-on clause in any existing trust deed (and reassessment). [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

Due-on-lease

The due-on clause is also triggered by:

- a lease with a term over three years; or

- a lease for any term when coupled with the grant of an option to purchase to the tenant. [12 CFR §591.2(b)]

For example, an owner with a short-term interim construction loan for nonresidential rental property obtains a conditional commitment from a long-term lender for take-out financing to pay off the construction loan. Funding of the take-out loan is conditioned on the property being 80% occupied by tenants with an initial lease term of at least five years.

The owner locates tenants for 80% of the newly constructed property, all with a lease term of five years or more. The lender funds the loan. The loan is secured by a trust deed lien on the property, which contains a due-on clause. The existing five-year leases do not trigger the due-on clause in the lender's trust deed. The long-term leases were entered into before the loan funded and the trust deed recorded.

However, after obtaining the loan, the owner continues to lease out space in his property for five year terms. Later, after interest rates rise, a representative of the lender (a prior loan officer) visits the property and "discovers" new tenants. On inquiry, the officer learns that some of the tenants entered into leases, or had their leases extended for periods greater than three years, after the loan was recorded.

The lender sends the owner a letter informing him it is calling the loan due since the owner has entered into lease agreements with terms over three years without their prior consent.

The owner claims the lender cannot call the loan since long-term leases were required by the lender as a condition for funding the loan.

Can the lender call the loan due or demand a recast of its terms?

Yes! By requiring leases with terms over three years as a condition for funding the loan, the lender did not waive its right to call or recast the loan under its due-on clause should a lease with a term over three years be entered into after the loan was originated.

However, an **assignment** or **modification** of an existing lease does not trigger the due-on clause, unless the lease is modified to extend the term beyond three years, or a purchase option is granted to the tenant.

For example, consider an owner of real estate who enters into a lease with an initial term of 10 years. Later, the owner takes out a loan secured by a trust deed containing a due-on clause. After the trust deed is recorded, the tenant assigns the lease with the owner's approval, as provided in the lease agreement (which has priority to the lender's trust deed).

However, the lender's due-on clause is not triggered by the lease assignment. The trust deed is attached as a lien only on the owner's fee interest, not the leasehold interest the owner previously conveyed to the tenant. The fee owner whose interest is encumbered by the loan transferred nothing. The assignment of a leasehold by a tenant is not a transfer of any interest in the fee encumbered by the trust deed.

However, consider a landlord who releases the original tenant from all liability under the lease as part of an assumption of the lease by the new tenant and substitution of liability. The release of the original tenant from liability creates a novation of the lease — a new agreement conveying an interest in the secured property to the new tenant by the owner of the fee. Since the novations included a leasing period of over three years, the lender may call the loan. [**Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424]

Thus, an assumption of the lease by a new tenant, and a release of the former tenant from liability by the landlord, constitutes a present transfer of an interest affecting the fee ownership of the real estate since it is a novation. Accordingly, a lease **novation** triggers the due-on clause — if the lease has a remaining term of over three years or includes an option to purchase.

Due-on-further encumbrance

An owner-occupant of a single family residence (SFR) subject to a first trust deed applies for an **equity loan** to be secured by a second trust deed on his property. The first trust deed contains a due-on clause.

The loan broker tells the owner he is concerned about due-on enforcement by the senior lender, since the execution of a second trust deed will convey a security interest in the property by encumbering it with a lien. On inquiry, the owner informs the broker he will continue to occupy the property as his residence.

Due-on enforcement and prepayment penalties

Consider an owner of real estate which is encumbered by a trust deed securing a note containing a **prepayment penalty clause**. The owner sells the property, triggering the due-on clause in the lender's trust deed.

The lender, unwilling to consent to an assumption by the buyer, calls the loan due. The buyer obtains a new purchase-assist loan from a different lender, enabling the buyer to pay off the existing loan.

The lender informs the buyer he will have to pay a prepayment penalty due to his early payoff of the loan.

The buyer claims he cannot be charged a prepayment penalty since the early payoff was not the buyer's choice, but was a result of the lender exercising his right to call the loan due-on-sale. Thus, the note is due by its terms.

Can a lender charge a prepayment penalty after calling a loan due?

Yes! The prepayment penalty clause in most trust deeds allows the lender to charge a penalty if the loan is **voluntarily or involuntarily** paid off before the due date**.**

Before 1983, a lender's prepayment penalty clause frequently called for a penalty only if the property owner voluntarily paid off the loan before the due date. Thus, the lender was barred from enforcing prepayment penalties in an *involuntary payoff*, after calling a loan due under the due-on clause. [**Tan** v. **California Federal Savings and Loan Association** (1983) 140 CA3d 800]

The lenders' response to the *Tan* decision was to reword their prepayment penalty clauses to impose a penalty for any prepayment of the loan, whether voluntary or involuntary.

However, when a loan is secured by a trust deed on owner-occupied, one-to-four unit residential property, federal regulations bar the lender from imposing a prepayment penalty when accelerating the loan under its due-on clause. [12 CFR §591.5(b)(2)]

The broker correctly assures the owner the second trust deed encumbrance will not trigger the senior lender's due-on clause, as long as the owner continues to occupy the residence. Due-on enforcement based on a further encumbrance of an owner- occupied, one-to-four unit residential property is not permitted. Equity loans are a source of consumer funds which stimulate the economy. [12 CFR §591.5(b)(1)(i)]

However, on real estate other than an owner- occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing lender's waiver of its due-on clause triggers the due-on clause, giving the lender the right to call or recast the loan.

Thus, junior financing without a waiver of the senior lender's due-on clause becomes a risky enterprise for trust deed investors in times of rising interest rates. Increasing market rates give trust deed lenders a powerful incentive to call loans on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

For example, a private lender accepting a junior trust deed position on a type of property other than an owner-occupied, one-to-four unit residence without first obtaining a **due-on waiver** from the senior lender risks having the economic value of his position in title:

- **reduced** by an increase in the interest rate on the first; or
- **wiped out** by the first's foreclosure, should the first exercise its due-on rights based on the further encumbrance and not be paid in full. [**La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864]

Owners are driven to look elsewhere for funds when the existing lender does not grant a due-on waiver. Thus an owner is forced to unnecessarily refinance existing encumbrances in order to generate cash from their equity in the property, a more expensive process due to prepayment penalties and increased rates than had they obtained an equity loan.

Now consider a seller who carries back a second trust deed on the sale of property without the consent of the holder of the first trust deed which contains a due-on clause.

The first trust deed lender learns of the sale and calls the loan. To avoid the call, the buyer assumes the first trust deed loan and modifies the note by shortening the due date.

The carryback seller claims his second trust deed now has priority over the first trust deed since the modification of the first trust deed note substantially impairs his security by increasing the potential for default on his trust deed.

Here, the modification of the first trust deed note without the consent of the junior carryback seller does not result in a change in trust deed priorities since the existence of the second trust deed note is in violation of the due-on clause in the first trust deed.

When the secured property is sold and the seller accepts a second trust deed without receiving the lender's prior written consent, the due-on clause has been breached under federal mortgage law. Thus, no duty is imposed on the first trust deed lender to avoid further subordinating the interest of the holder of the unconsented-to junior lien by recasting the first trust deed note. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

Due-on-foreclosure

A parcel of real estate is subject to a first trust deed lien and second trust deed lien to which the first consented. The property owner defaults on the first trust deed. The junior trust deed holder reinstates the first trust deed and forecloses on the second, acquiring the property at the trustee's sale. At all times the second trust deed holder kept the first trust deed current.

The senior lender informs the junior lender, who now owns the property, that it is calling its loan due, based on the transfer of the property by trustee's deed.

Can the senior lender call its loan due based on the completion of foreclosure by the second trust deed lender?

Yes! A senior lender may call a loan due on completion of the **foreclosure sale** by a junior lender or carryback seller on any type of real estate. A *trustee's deed* on foreclosure is considered a voluntary transfer by the owner, since the power of sale authority in the junior trust deed was agreed to by the owner of the real estate.

However, the due-on clause is not only triggered by the voluntarily agreed-to trustee's sale, but also by any involuntary foreclosure, such as a tax lien sale. [**Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423]

Federal regulations allow due-on enforcement on **any transfer** of real estate which secures the lien, whether the transfer be voluntary or involuntary. [12 CFR §591.2(b)]

The risk of a senior lender enforcing its due-on clause on a trustee's sale by the junior lender has a **debilitating effect** on the availability of junior trust deed loans and carryback sales. Prudent lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt should they be forced to foreclose on the real estate. [**Pas** v. **Hill** (1978) 87 CA3d 521]

Due-on-death and exceptions

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner even if title was vested in a revocable inter vivos trust. However, as with due-on enforcement triggered by further encumbrances, narrow exceptions apply to the death of an owner who occupied a one-to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause, on the condition the relative becomes an occupant of the property. [12 CFR §591.5(b)(1)(v)(A)]

Also, where two or more people hold title to one-to- four unit residential property as joint tenants, the death of one **joint tenant** does not trigger due-on enforcement as long as at least one of the joint tenants, whether it was the deceased or a surviving joint tenant, occupied the property at the time the loan was originated. Occupancy is not required for a surviving joint tenant who qualifies for the joint tenancy exception. [12 CFR §591.5(b)(1)(iii)]

In all other transfers, the death of a vested owner, joint tenant or other co-owner will trigger the lender's due-on clause. Thus, due-on enforcement is **triggered on death** by:

- a transfer of the deceased's residence to a non-relative, by will or by trust, following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which was not originally occupied by any of the surviving joint tenants;
- the death of a co-owner of any type of property other than one-to-four residential units; and
- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

Divorce and inter-family transfers

A married couple occupies a residence which is vested in the name of the husband and owned as his separate property. The residence is subject to a trust deed containing a due-on clause.

The couple separates and the residence is transferred to the wife as part of the **property settlement** to dissolve the marriage. The wife continues to occupy the residence.

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the lender?

No! Federal due-on regulations bar due-on enforcement on transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property. [12 CFR §591.5(b)(1)(v)(C)]

However, if the acquiring spouse chooses to lease the residential property to tenants for any length of time rather than occupy it, the lender can call or recast its loan.

Also, the due-on clause is not triggered by an owner's transfer of his one-to-four unit residential property to a **spouse or child** who occupies the property. [12 CFR §591.5(b)(1)(v)(B)]

This inter-family transfer exception for four-or-less residential property applies only to transfers from an owner to a spouse or child. For instance, any transfer from a child to a parent to provide housing for the parent triggers due-on enforcement.

Finally, consider an owner-occupant of one-to-four unit residential property who transfers the property into an *inter vivos trust*, naming himself as beneficiary. The owner continues to occupy the property after transferring title into the trust, commonly known as a living trust.

The owner **notifies the lender** he will be transferring title into the trust vesting. The owner agrees to give the lender notice of any later transfer of his beneficial interest in the trust or change in occupancy of the property as requested by the lender.

Would this transfer into a living trust trigger the due-on clause in a trust deed encumbering the owner's residence?

No! The owner met the federal regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an inter vivos trust. [12 CFR §591.5(b)(1)(vi)]

To meet regulations, the owner must provide means **acceptable to the lender** by which the lender will be given notice of any later transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the lender's approval of the notice provision, the lender may call the loan due.

The notification provision requires the owner to first obtain the lender's consent before transferring the property into a trust vesting.

Also, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the lender can call or recast the loan.

Waiver by negotiation and by conduct

Under federal regulations, lenders have the power to dictate the fate of financing in most real estate transactions, since most real estate is encumbered by adhesion trust deeds containing due-on clauses.

However, an owner wishing to enter into a transaction to sell, lease or further encumber his real estate without lender interference must first negotiate a **limitation or waiver** of the lender's due-on rights.

Waiver agreements are basically trade-offs. The lender will demand some consideration in return for waiving or agreeing to limit the exercise of its due-on rights in the future, such as increased points on origination, additional security, principal reduction, increased interest and larger payments, a shorter due date or an assumption fee.

For example, a buyer applies for a loan to purchase a residence which he intends to occupy for only a few years. The buyer is concerned due-on enforcement will later make it more difficult for him to resell the property since it will limit the seller's ability to finance the sale of his equity.

Thus, the buyer and the lender negotiate the conditions on which a qualified buyer in a later sale of the property will be able to assume the loan without a call by the lender. In exchange for the lender's limitation of its future due-on rights, the buyer agrees to pay increased points or interest.

Any time a lender recasts a loan as a condition for consenting to a buyer's assumption, it is essentially forcing a *modification agreement* on the buyer. In exchange for agreeing not to call the loan due on a transfer of the property to the buyer, the lender receives consideration, such as increased interest and payments (the modification of the loan) and an assumption fee.

The lender's waiver of its due-on rights under an assumption agreement applies only to the present transfer to the buyer. Unless additionally agreed to, any **later transfer** of an interest in the property will trigger the due-on clause, allowing the lender to call or recast the loan again.

In addition to a waiver (assumption) agreement, waiver of the lender's due-on rights may occur **by conduct** — the lender loses its due-on rights by failing to promptly enforce them.

For example, a buyer purchases real estate subject to a loan secured by a trust deed containing a due-on clause. The lender is informed of the transfer and immediately calls the loan. However, the lender then accepts payments from the buyer for over a year. Finally, the lender seeks to enforce its prior call by refusing further payments and foreclosing.

However, the lender, **by its conduct**, waived the right to enforce its due-on clause. The lender accepted payments from the buyer for over a year after calling the loan on learning of the transfer of the real estate. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

Broker liability for due-on avoidance

When the seller intends to transfer ownership of the property to the buyer, the senior lender's due-on clause is triggered regardless of the form used to document the sales transaction.

Of course, the lender can only call the loan when it actually discovers a change of ownership has taken place. If the buyer's option is not recorded, and the lease agreement is for a term under three years, the lender might not discover any transfer of an interest in the real estate has taken place, which triggered its due-on clause.

If the lender later discovers a change of ownership has taken place, its only remedy against the buyer and seller is to call the loan due, or arrange to recast the loan as a condition for waiving its right to call and allowing an assumption by the buyer. Under the note and trust deed, the lender cannot recover the *retroactive interest differential* (RID) for the period before it discovered the transfer and called the loan. The only recourse against the buyer or seller is to call the loan and be paid in full or foreclose. [**Hummell** v. **Republic Federal Savings & Loan** (1982) 133 CA3d 49]

However, **an adviser**, such as a broker or attorney, assisting the buyer or seller to mask the change of ownership from the lender with the primary purpose of avoiding the lender's due-on enforcement, can be held liable for wrongfully interfering with the lender's right to call or recast the loan, an offense called *tortious interference with prospective economic advantage*.

The adviser's liability arises based on the extent to which his actions were **specifically intended** to conceal the transfer and prevent a call by the lender, and on the **foreseeability** the lender would incur losses due to the concealment. [**J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799]

The lender's losses caused by the adviser's wrongful interference are calculated based on the *interest differential* between the note rate and the market rate on the date of sale, retroactively applied from the date of discovery by the lender to the date of the transfer.

Chapter 22 — Assumptions: formal and subject-to

This chapter explores the financing procedures available to a buyer when negotiating to take over an existing loan which encumbers the seller's property.

Loan takeovers by buyers

On the sale of a parcel of real estate, any existing financing encumbering the property may remain of record and be taken over by a buyer under one of four procedures:

- a **formal assumption** between the lender and the buyer;
- a **subject-to assumption** between the seller and the buyer;
- a **subject-to transfer** of ownership without an assumption agreement of any type; and
- a **novation** between the lender, seller and buyer.

Consider a seller of real estate which is encumbered by a first trust deed. The seller enters into a purchase agreement and escrow instructions which provide for the buyer to **take title subject-to** the existing loan encumbrance. [See **first tuesday** Form 150 §§ 5 and 6]

The buyer plans to close escrow on the subject-to transfer without entering into a written assumption agreement with the lender. The buyer intends to negotiate with the lender after closing if the lender calls the loan or demands an assumption. If not, the buyer will refinance the existing loan with another lender.

The interest rate on the seller's existing loan is at or above current market levels. Due to the buyer and his broker's experience with the lender, the buyer feels the lender will not call the loan and demand a payoff or assumption. If it calls the loan, the buyer reasons the lender will lose either its servicing fees or its high portfolio yield on the loan, depending on whether the lender owns the loan or is servicing the loan for another lender.

A beneficiary statement is requested by escrow. The lender properly complies with the request by sending a statement of the loan condition to escrow within 21 days of its receipt of the request. [Calif. Civil Code §2943(e)(3); see Chapter 18]

However, the lender unilaterally **instructs escrow** not to close until the buyer has been approved by the lender and has assumed the loan since the lender's trust deed contains a due-on clause.

Can the lender interfere with the closing of a subject-to transaction when the buyer and seller do not instruct escrow to process a lender approval or loan assumption?

No! Escrow instructions for the sale of property subject to the existing loan are entirely between the buyer, seller and escrow. The lender has no legal right to interfere with the transaction to prevent the closing since it is not a party to the escrow.

Further, escrow has no authority from its principals to follow any lender instructions attached to the beneficiary statement. The lender's remedy – and leverage to force a modification or payoff – is limited to calling the loan under its due-on clause in the trust deed after the subject-to transaction is closed, if the lender chooses to do so. [**Moss** v. **Minor Properties, Inc.** (1968) 262 CA2d 847]

The subject-to transaction

A subject-to transaction is initially structured by use of a financing provision in a purchase agreement which calls for the amount of an existing loan to be part of the purchase price the buyer is to pay for the property. The financing provision states the buyer is to take title to the property subject to the existing loan. [See **first tuesday** Form 150 §§5 and 6]

The seller's representation of the terms and condition of the loan is confirmed by the buyer during escrow on escrow's receipt of the lender's **beneficiary statement**. The buyer can rely on the beneficiary statement for future payment schedules, interest rates and loan balances in spite of the lender's attempts to conditionalize the use of the beneficiary statement on the buyer's assumption of the loan.

Some buyers do not instruct escrow to order a beneficiary statement, fearing the notice of the sale may cause the lender to **call or modify** the loan after escrow closes. The seller's most recent loan payment receipt or loan statement might then be used as the source of loan information. However, the buyer must be aware the lender is not bound by the payment statements as it is bound by the beneficiary statement. [See Chapter 18]

Some buyers acquire their ownership rights under **unrecorded sales documents**, such as lease-option agreements or land sales contracts. Thus, the seller and buyer completely avoid conveyances, escrow, title insurance, and other customary transfer activities until they can either work out an assumption or originate new financing. However, these unrecorded sales documents do trigger due-on clauses and reassessments, as well as create risks of loss inherent in an unrecorded transaction that leave room for misunderstandings about who owns the property.

During periods when current market interest rates are comparable to or lower than the note rate on an existing loan:

- a **beneficiary statement** should be ordered to confirm the loan amount and loan terms;
- the change of ownership conveyance should be **recorded and insured**; and
- the conveyance should promptly be brought to the **lender's attention** so it cannot wait and later call the loan when rates rise by claiming the transfer went undisclosed.

Conversely, during periods of rising or high interest rates, as compared to the note rate on an existing loan, the lender is often not notified of a subject-to sales transaction. Notice of the transaction would allow the lender to gain financially from a call or recast of the loan at the seller's and buyer's expense.

However, the lender can enforce its due-on clause and call the loan on its *future discovery* of any sale, regardless of how the sale is structured. Also, on a later discovery of the transfer, any brokers, attorneys or accountants whose **primary objective** in negotiating the sales transaction was to induce the buyer and seller into avoiding the due-on clause may be liable to the lender (in tort) for any *retroactive interest*

differential (RID) lost by the lender based on market rates at the time of the transfer. A *hold harmless agreement* from the seller or buyer would be appropriate for providing indemnity to the agents and brokers negotiating the undisclosed transaction. [See Chapter 21]

The seller of property, sold either subject-to or by an assumption of the seller's loan, should be concerned about his liability for the loan after it is taken over by the buyer. Seller liability depends on whether the loan is a recourse or a nonrecourse loan, unless the lender's loss is a result of its error on a beneficiary statement or a payoff demand. [See Chapter 46]

Nonrecourse debt

A seller is not liable for a deficiency on the foreclosure of a *purchase-money* debt taken over under any procedure by the buyer, since they are nonrecourse debts.

Purchase-money obligations secured by real estate include:

- seller carryback financing on the sale of any type of real estate which becomes the sole security for the carryback note;

- a loan or debt which funded or financed the purchase of an owner-occupied, one-to-four unit residential property [Calif. Code of Civil Procedure §580b]; and

- a loan made for the construction of an owner-occupied, single family residence (SFR), and perhaps a loan made to improve the structure (the legal status of dwelling improvement loans remains uncertain).

A lender may only resort to the secured property by foreclosing on it to recover the balance due when a default occurs on a **purchase-money loan**. [CCP §580b]

Even if the secured property has insufficient remaining value to satisfy the balance of the purchase-money loan, the lender cannot hold the original borrower or a subsequent assuming buyer personally liable on the nonrecourse note for the deficiency in the property value (unless the lender may recover from the buyer who inflicts waste on the property).

On the take-over of a purchase-money loan by a buyer, the loan retains its original non-recourse purchase-money characteristics, regardless of whether the buyer takes title subject-to or assumes the loan, or a novation occurs. [**Jackson** v. **Taylor** (1969) 272 CA2d 1]

Thus, a non-occupying buyer who takes over a purchase-money loan under any procedure is entitled to anti-deficiency protection. In contrast, **purchase-assist** financing originated by a non-occupying buyer of any type of residential property, including one-to-four unit residential property, would be a recourse loan, not a purchase-money loan.

However, while the lender may have no recourse to the buyer, if the loan is insured by the Federal Housing Administration (FHA) and the Veterans Administration (VA), the FHA or the VA have recourse to the borrower who signed the note for losses on a foreclosure and resale of the property. [See Chapter 39 and 40]

Recourse real estate loans

Recourse loans are all loans not classified as **purchase-money loans**, as reviewed above.

Consider a buyer who takes title to property subject to a seller's existing home equity loan which is a recourse (liability) loan. The loan proceeds were not used to purchase or improve the seller's residence.

The buyer defaults on the loan and the lender initiates and completes a judicial foreclosure (not a trustee's sale) on the property. The fair market value of the property at the time of the judicial foreclosure sale is insufficient to fully satisfy the loan, resulting in a deficiency.

The lender now seeks a money judgment against the seller for the amount of the deficiency in the property's value since the judicial foreclosure sale did not fully satisfy the loan amount. The seller claims he is not responsible for the loan since it was taken over by the buyer.

Is the seller liable for the deficiency on the recourse loan after the buyer takes title to the secured property subject to the existing loan?

Yes! When property is sold and its title is conveyed to a buyer **subject-to** an existing recourse loan, the seller remains liable for any deficiency on the recourse loan should the buyer fail to pay. [**Braun** v. **Crew** (1920) 183 C 728]

Further, unless the buyer enters into an **assumption agreement** with either the seller or the lender, a subject-to buyer is not liable to either the seller or the lender for a drop in the property's value below the loan balance (unless the buyer damages the property to an extent which decreases its value, called *waste*). [**Cornelison** v. **Kornbluth** (1975) 15 C3d 590; CC §2929]

However, if the subject-to buyer and the lender enter into an assumption agreement which significantly modifies the terms of the recourse loan without the seller's consent, the seller cannot be held liable for the loan. [Braun, *supra*; CC §2819]

Buyer-seller assumption

A seller can reduce his risk of loss on a buyer's takeover of a **recourse loan** by negotiating the adoption of a provision in the purchase agreement which requires the buyer to enter into an **assumption agreement** with the seller.

A buyer-seller assumption agreement is not to be confused with a so-called *formal assumption* between the buyer and a lender.

The buyer-seller assumption agreement, agreed to in the purchase agreement and prepared in escrow, is a promise given by the buyer to the seller to perform all the terms of the loan taken over by the buyer on the sale. [See Form 431 accompanying this chapter]

The assumption agreement gives the seller the right to collect from the buyer the amount of any deficiency judgment a recourse lender might be awarded against the seller in a judicial foreclosure. To be enforceable by the seller, the assumption agreement must be in writing. [CC §1624]

Although the buyer's promise to pay the loan under a buyer-seller assumption agreement is given to the seller, the buyer also becomes liable to the recourse lender under the legal doctrines of *equitable subrogation* and *third-party beneficiaries*. [Braun, *supra*; see Form 431 §6]

ASSUMPTION AGREEMENT

Unsecured and Subrogated

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This assumption agreement is entered into by

1.1 ____, as the Buyer,

1.2 and ____, as the Seller,

1.3 regarding Buyer's acquisition of real estate referred to as ____

____.

2. FIRST TRUST DEED NOTE:

2.1 Buyer is acquiring title to the real estate subject to a first trust deed dated ___________________________,

2.2 executed by ____, as the Trustor,

2.3 in which ____ is the Beneficiary,

2.4 recorded on ________________________, as Instrument No.___________________, in the Official Records of ____ County, California, and

2.5 given to secure a promissory note of the same date for the principal sum of $_______________.

3. SECOND TRUST DEED NOTE:

3.1 Buyer is acquiring title to the real estate subject to a second trust deed dated ________________________,

3.2 executed by ____, as the Trustor,

3.3 in which ____ is the Beneficiary,

3.4 recorded on ________________________, as Instrument No.___________________, in the Official Records of ____ County, California, and

3.5 given to secure a promissory note of the same date for the principal sum of $_______________.

AGREEMENT:

4. Seller hereby assigns and delegates to Buyer all rights and obligations in the above note(s) and trust deed(s).

5. Buyer hereby assumes and agrees to timely pay the debt evidenced by the above promissory note(s) and to perform all of Trustor's obligations under the trust deed(s) securing the note(s).

6. This agreement is made for the benefit of the Beneficiary(ies) of the trust deed(s) securing the note(s).

7. Should Buyer or Buyer's successors default in the performance of this agreement, the whole sum of the principal and interest on the assumed indebtedness(es) shall become immediately due at the option of the holder of this assumption agreement.

7.1 On default, Seller shall become subrogated to the interest of Beneficiary under the defaulted note and trust deed.

8. In any action to enforce this agreement, the prevailing party shall receive attorney fees.

I agree to the terms stated above.

Date:_____________, 20______

Seller: ____

Seller: ____

I agree to the terms stated above.

Date:____________, 20______

Buyer: ____

Buyer: ____

Even though the buyer, upon entering into any type of assumption agreement, takes over the primary responsibility for the recourse loan, the seller remains **secondarily liable** to the lender. The seller's risk of loss arises when the buyer fails to pay the recourse loan and there is a lack of market value remaining in the property to cover the loan amount. [**Everts** v. **Matteson** (1942) 21 C2d 437]

Unlike the subject-to seller, the seller under the buyer-seller assumption agreement is entitled to be *indemnified* (held harmless) by the buyer for any losses the seller later incurs due to his continued liability on the recourse loan taken over by the buyer.

To avoid the delay in pursuing reimbursement from the buyer for any loss covered by the buyer-seller assumption agreement, sales negotiations calling for the buyer to enter into an assumption agreement with the seller may also call for the buyer to **secure the assumption** agreement by a *performance trust deed* carried back by the seller as a lien on the property sold. [See **first tuesday** Forms 432 and 451]

With a recorded trust deed held by the seller to secure the buyer's promise to pay the lender as agreed in the assumption agreement, any default by the buyer on the loan allows the seller to:

- demand the buyer to tender the entire balance remaining due on the assumed loan, subject to the buyer's right to reinstate the delinquencies; and

- proceed with foreclosure under the performance trust deed to recover the property and cure the default on the loan assumed by the buyer.

A buyer-seller assumption, like a subject-to transaction, does not alter the lender's right to enforce its due-on clause on discovery of the conveyance, unless the lender has waived its due-on rights by failing to call the loan or promptly act on a call after acquiring knowledge of the transfer of ownership.

Novation

Consider a buyer who is willing to cash out theseller's equity and assume an existing recourse loan with the lender. However, the seller is unwilling to sell the property and remain liable for the loan after closing when he no longer has an interest in the property.

Can the sale be closed without the seller remaining liable on the recourse loan assumed by the buyer?

Yes! The lender can enter into an agreement with both the buyer and the seller for the buyer's **assumption** of the loan and a **release** of the seller's liability, an agreement called a *novation* or *substitution of liability*, for which the lender charges a fee and may demand a modification of the loan terms.

On a buyer-lender assumption of a loan secured by an owner-occupied, one-to-four unit residential property, the lender is required to **release the seller from liability** for the loan assumed by the buyer. [12 Code of Federal Regulations §591.5(b)(4)]

A **novation agreement** is comparable to the existing lender originating a new loan with the buyer, except the trust deed executed by the seller remains of record and the note remains unpaid.

Thus, the lender under a novation agreement (or an assumption) will review the buyer's credit status, seek a modification of the interest rate to current levels, and charge an assumption fee which are all benefits a lender would have received on an origination of a new loan made to the buyer.

However, any lender collection of fees or an increase in the interest rate on the loan, called *portfolio yield*, defeats most of the advantages a buyer and seller have when taking title subject to an existing loan.

Chapter 23 FHA and VA loan assumptions

This chapter reviews Federal Housing Administration (FHA) and Veterans Administration (VA) enforcement of assumption rules for loans they have insured.

Avoiding fees and investor prohibitions

An investor and his real estate agent discuss the investor's intent to add more single family residences (SFRs) to the pool of rentals he has owned for some time, a client situation called *counseling*. The investor is interested in inexpensive homes recently financed with maximum loan-to-value (LTV) fixed-rate loans insured by the Federal Housing Administration (FHA).

Specifically, the investor wants to **take over** existing financing rather than obtain new financing to fund his purchase of the SFRs. His cash reserves will be used to upgrade the properties. The investor is aware that the interest rate and the mortgage insurance premium (MIP) on FHA loans is higher by approximately 0.6% than conventional loans with private mortgage insurance (PMI), the result of greater leverage.

The investor's agent explains that the trust deed FHA uses for loans insured by the Department of Housing and Urban Development (HUD) includes a *due-on-sale clause*. In order to prevent investors from acquiring SFRs with FHA-insured financing, the **due-on-sale** provision allows HUD to call loans taken over by investors.

The reason for discouraging investors from taking over loans is HUD's need to reduce the number of defaults on FHA loans, since investor-owners generally have a high default rate compared to owner-occupants of SFRs.

However, the investor is made aware that before the lender can *call* an FHA-insured loan on the sale of the SFR property, the lender must first obtain HUD's approval. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-7 §1.b]

In practice, HUD does not grant the right to call unless a default already exists. Thus, lenders are limited to using the due-on clause as a device to pressure an investor to assume the loan, typically accomplished by contacting the seller prior to the close of escrow. The objective of lenders is *revenue*; they obtain it by demanding and receiving an assumption fee of one-half point or more on the sale and ignoring HUD's late-80s no-investor rule.

Taking over an FHA loan

Prudent long-term investors seek out desperate property owners who are in default, then pay little or no money down and convert the property to a rental unit based on the investment fundamentals of "price, time and location." The best time for property acquisition is during a crisis, such as a recession, when the market is temporarily devoid of sufficient buyers to keep prices at their past levels and selection within prime rental areas is extensive.

However, some individuals entering the real estate market are not in the ownership of real estate for long-term income benefits, but are *speculators* entering the market during boom times intending to immediately flip the property upon buying it, without investing any further capital. In doing so, they often do not make payments to the lender, looking only to pay off the loan on a prompt resale.

Homeowners' associations (HOAs) and the local tax collector (supplemental tax billings) also get burned by the conduct of speculators as they sandwich themselves in between sellers and homebuyers or rental investors to withdraw wealth from the real estate market.

Speculators often collect and keep rent without making payments on the loan, called *rent skimming*, or *equity skimming* if done on a scale of five or more units. **Rent and equity skimming** is a crime under federal and state law. [12 United States Code §1709-2; Calif. Civil Code §§890 et seq.]

In response to the activities of rent-skimming speculators during the 1980s, HUD prohibits investor assumptions on FHA-insured SFR loans. Thus, FHA will only allow the assumption or take-over of an FHA-insured SFR loan by qualified owner-occupant buyers. HUD has the right to call the loan if taken over by anyone other than a homebuyer. [HUD 4155.1 Ch-7 § 1.b]

However, in spite of the HUD due-on enforcement policy, only with HUD's prior approval can the servicing lender call the loan on a subject-to transfer to an investor. As a matter of practice, HUD has not authorized a call when an investor acquires the property, unless the investor defaults on loan payments.

Closing sales subject to FHA-insured loans

Rental investors and unqualified buyers who have the financial ability to make payments on an FHA loan encumbering property they have agreed to purchase should obtain a beneficiary statement from the lender, through escrow, to confirm the seller's representation of the loan terms.

The buyer then closes escrow, taking over the loan by either:

- cashing out the seller's equity; or
- combining cash and a note carried back by the seller to pay for the seller's equity.

The seller's risk of FHA recourse

Sellers must be made aware of their **risk of loss** when permitting a buyer to take title subject-to their FHA loan.

The downside risk for a seller of a property encumbered by an FHA-insured loan is his **personal liability** for any loss the FHA may incur due to a deficiency in the property value at the time of a default by the buyer. This deficiency in the property value might occur after the close of escrow.

If the subject-to buyer fails to make payments on the FHA loan, and the property's value becomes insufficient to satisfy the remaining loan balance, HUD has the right to collect a deficiency from the original borrower.

The right to pursue the original borrower for any deficiency belongs to HUD, not the lender.

Borrowers under programs insured by the FHA or Veterans Administration (VA) do not receive California **anti-deficiency protection** for losses sustained by these federal agencies. The federal statutory right to collect losses on the HUD loan insurance program preempts state law to the contrary. [**Carter** v. **Derwinski** (9th Cir. 1993) 987 F2d 611]

Thus, the seller, on a transfer of title subject to an FHA loan, should consider entering into an *assumption agreement* with the buyer and securing the agreement by a performance trust deed. [See **first tuesday** Forms 432 and 451]

Then, if the buyer does not perform on the **assumption agreement** by making payments on the loan, the seller may call all amounts due by the terms of the assumption agreement and foreclose under the trust deed to protect his interests.

Release of liability

To be released from liability for any deficiency on an FHA-insured loan taken over by a buyer, a seller must obtain a formal *release of liability* as part of the assumption package presented by the lender on an FHA-insured loan. [HUD 4155.1 Ch-7 § 1.e]

A **release of liability** will be granted by the lender if:

- the seller requests a release from personal liability;
- the prospective buyer is creditworthy;
- the prospective buyer assumes the loan; and
- the lender uses an FHA-approved form to release the seller from personal liability. [HUD Form 92210.1; 24 Code of Federal Regulations §203.510(a)]

If the conditions for a release of liability exist, but the seller does not request the release from personal liability, the seller remains liable to the FHA for any losses due to a default occurring within five years after the sale. [12 USC §1709(r)]

However, after five years pass from the time the property is resold, the seller is released from personal liability, if:

- the buyer assumes the loan with the lender;
- the loan is not in default at the end of the five-year period; and
- the seller requests the release of liability from the lender. [24 CFR §203.510(b)]

Many owners sell their homes subject-to FHA-insured loans knowing full well the risks of a deficiency. However, sellers generally believe future appreciation and HUD's recent refusal to pursue collection of loan losses minimize any real risk of value-deficiency exposure.

In economically depressed parts of the country, property is conveyed subject-to FHA-insured loans as a way to obtain buyers, an activity which tends to decrease the level of foreclosures against homeowners who can no longer afford to own the home or must relocate for job opportunities.

Conversely, a demand for a substitution of liability and assumption fees on a loan takeover tends to drive potential buyers away. Thus, the price of homes is driven down, adversely affecting the level of foreclosures and increasing the risk of loss in homeownership.

FHA inactivity on a sale

Any hesitation a seller may have about selling a single family residence (SFR) subject-to an FHA-insured loan is put at ease by HUD's internal policy not to collect deficiencies against owners who made loan payments in **good faith**.

After foreclosure by a lender, the FHA pays the lender for any loan losses under their mortgage insurance policy (MIP) or acquires the property by paying off the loan. If acquired, the FHA resells the properties to offset its losses. FHA then sends collection letters but does not hav ea history of otherwise contacting the homeowner.

Sellers who receive cash for their entire equity occasionally ignore the loan assumption provision and lender threats, and close subject to a FHA-insured loan.

Sellers with well-seasoned loans, or who are extremely motivated to sell, might disregard the due-on clause when selling their home.

HUD, with its **no-investor policy**, severely cripples a defaulting seller's ability to sell his home and financially right himself, or obtain mobility to relocate to a better job.

If HUD's no-investor policy were enforced, it would tend to increase the number of FHA repossessions and cause unemployment levels to remain higher than if owners could move to where the jobs are, which are undesirable effects.

Thus, buying a residence subject-to an FHA-insured loan, regardless of when the loan was originated, will likely continue without government interference and lender assumption threats, so long as the loan is kept current.

Assuming a VA loan

The VA loan assumption policy is entirely different from the HUD/FHA assumption policy.

A buyer of property secured by a VA-guaranteed loan may take over the loan if:

- the loan is **current**;
- the buyer **assumes** the loan; and
- the buyer is **creditworthy**. [38 USC §§3713(a); 3714(a)(1)]

For a buyer to assume a VA loan, a fee of 0.5% of the loan balance is to be paid to the VA by the buyer. [38 USC §3729(b)]

The VA **assumption fee** is to be paid to the lender on closing the sale with the buyer. The lender has 15 days to forward the fee to the VA or the lender will face late charges. [38 CFR §36.4312(e)(2)]

Additionally, the lender can charge and retain an assumption fee of the lesser of:

- $300, plus the costs of a credit report; or
- the maximum amount for an assumption fee allowed under state law. [38 CFR §36.4312(d)(8)]

While no statutory rule exists in California for calculating assumption fees, the fees should reflect actual out-of-pocket costs, or reasonable cost estimates for processing the assumption.

When an assumption application is approved by the lender, the VA borrower is released from further liability to the VA under the mortgage insurance program, including liability for losses caused by the buyer's default in payments. [38 CFR §36.4323(h)]

However, the veteran who is released by the VA is not necessarily released by the lender from further liabilities for the loan. For instance, the veteran who **refinances** his home with a VA insured loan has liability under the loan (as well as to the VA) for any deficiency in the property value to cover the loan.

The veteran exposed to refinancing liability should consider negotiating and entering into a *novation agreement* with the lender in order to be relieved of liability for a potential deficiency. Liability to a lender for a loan used to refinance a property is different from the mortgage insurance liability the veteran has with the VA.

A **novation agreement** requires the consent by three parties — the buyer, seller and lender — to release the seller from further liability to the lender when the seller is released from mortgage insurance liability by the VA under a *substitution of liability*.

If the lender refuses to allow the buyer to assume the loan, the VA may review the findings and determine whether the buyer is entitled to assume the loan.

If the veteran is unable to make payments on his VA-insured loan, but finds a qualified buyer to assume the loan, the VA may require the lender to agree to the loan assumption since it is in the best interest of the VA. [38 USC §3714(a)(4)(B)]

However, neither the lender nor the VA have to release the seller from liability on the loan when the assumption is granted to avoid foreclosure. [38 CFR §36.4323(h)]

If the VA refuses to allow the buyer to assume the loan, and the veteran borrower sells the property nonetheless, the lender may call the loan and demand payment of the remaining principal and interest without prior approval from the VA. [38 USC §3714(a)(4)(C)]

Also, the lender may call the VA loan if the veteran borrower sells his personal residence and fails to notify the lender of the sale. [38 USC §3714(b)]

However, when a lender becomes aware the veteran borrower sold the property secured by a VA loan and the lender fails to notify the VA, then the lender, not the seller, will be liable for any VA losses on the loan. [38 USC §3714(c)(1), (2)]

Chapter 24 Personal property as security

This chapter reviews the documentation in real estate transactions where personal property becomes additional security for a debt.

A lien on additional collateral

A real estate agent lists a furnished apartment complex for sale. The sale will include inside and outside furnishings, refrigerators and maintenance equipment.

The seller of the apartment complex is willing to carry a note secured by a trust deed on the property.

The seller's agent advises the seller the furnishings and maintenance equipment he is selling and transferring on a bill of sale will be **additional security** for any carryback note. Thus, the seller's risk of loss will be minimized should it become necessary to foreclose.

Likewise, loan brokers arrange short-term money loans with private lenders. Since brokered loans made by private lenders usually are secured by second trust deeds on a borrower's real estate, these lenders often want additional security. Additional security might take the form of personal property, such as furnishings, business inventory, equipment, machines or business revenue (accounts receivable).

Two documents are involved to properly secure a debt with personal property:

- a **security agreement** which creates a lien on the personal property; and
- a **financing statement** which is recorded to give public notice of the lien.

To **create a lien** on personal property transferred in a sale of real estate, an agreement is entered into which grants the carryback seller or lender a security interest in the form of a lien on the personal property described in the agreement, called a *security agreement.*

To put the public on **notice of the lien** created by the security agreement, a UCC-1 Financing Statement (UCC-1) is prepared and filed, which is called *perfecting the lien*. The filing is a recording of the UCC-1 with the Secretary of State or with the county recorder, depending on the type of personal property and its relationship to the real estate. [Calif. Commercial Code §§9310; 9501]

Perfecting the lien establishes the carryback seller's interest and priority over all other security interests in the personal property granted to or acquired by others and filed after the seller's UCC-1 is recorded.

A carryback seller should not use a trust deed as a security device to create a lien on personal property. A recorded trust deed imposes a perfected lien on real estate, not personal property.

Personal property defined

All property is divided into two categories — real property, commonly known as *real estate*, and personal property, also called *personality*.

Real estate includes land and anything affixed or appurtenant to it, such as buildings, trees or rivers. [Calif. Civil Code §658]

Every kind of property which is not real estate is classified as **personal property**. [CC §663]

Thus, personal property includes:

- **tangible goods**, such as furniture, equipment and vehicles;
- **general intangibles**, such as the good will of a business, accounts receivable and business income;
- **instruments and documents**, such as promissory notes, whether or not secured by a trust deed lien; and
- other items, such as cash and contract rights.

Rents form a separate category of personal property. Rents become security for a debt under a lien called an *assignment of rents provision* typically included in a trust deed. [See Chapter 17]

Real property vs. personal property

A *real estate fixture* is personal property which is permanently attached or affixed to the land or buildings located within the parameters of a parcel of real estate, and is part of that real estate. [CC §660]

For example, an air conditioning unit in an apartment complex is a **real estate fixture** since it is a necessary, integral part of the building. On the other hand, furniture is not a real estate fixture since it is not permanently attached to the building.

Fixtures which are used as part of a trade or business are called *trade fixtures*, such as the equipment and sinks in a restaurant, or chairs and plumbing fixtures affixed to the floor and walls in a beauty salon.

Trade fixtures, like real estate fixtures, are often affixed to the real estate. However, they remain personal property items since they are necessary to the operation of the business on the premises, not the use of the real estate itself. [**Beebe** v. **Richards** (1953) 115 CA2d 589]

Whether an item is a real estate fixture or personal property is resolved by the application of a three part test:

- the permanence of the item's attachment to the real estate;
- the degree to which the real estate was constructed to support the fixtures; and
- the parties' intentions when the items were attached to the real estate. [**Security Data, Inc.** v. **County of Contra Costa** (1983) 145 CA3d 108]

Intent is the crucial, overriding factor in determining whether an item is personal property or a real estate fixture. [**Seatrain Terminals of California, Inc.** v. **County of Alameda** (1978) 83 CA3d 69]

Intent to establish a fixture as real estate or personal property is usually manifested in an agreement.

SECURITY AGREEMENT

For Note Secured by Personal Property

NOTE: Recommended for use with **first tuesday** Form 435.

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This agreement provides security for the payment of a promissory Note in the amount of $___________________,

1.1 ☐ of same date, or dated __________________, 20________, at _______________________, California,

1.2 executed by ____, as the Debtor, and

1.3 ____, as the Creditor.

2. Debtor hereby grants to Creditor a security interest in the following personal property ________________________

____

____

____

____.

3. The personal property is located on real estate referred to as ____

____

____.

4. A UCC-1 financing statement will be executed concurrent with this agreement.

5. The Note is additionally secured by a trust deed entered into by the parties:

5.1 dated __________________, at ____, California,

5.2 regarding real estate referred to as ____,

5.3 recorded on __________________, as document number _____________,
in the County of ____, California.

6. Should Debtor offer to sell, accept an offer to purchase, lease or encumber the personal property or his interest in the promissory Note, or remove the personal property from its location without Creditor's written consent, Creditor may call the promissory Note immediately due.

7. Debtor will maintain insurance on the personal property against risks of fire, theft, vandalism and other extended coverage risks in an amount sufficient to protect the promissory Note.

8. Any advances made by Creditor to protect the security from impairment, or for property taxes, insurance or defense of title, including reasonable costs and attorney fees, shall be reimbursed by Debtor on demand, and if not paid to be added to the amount due on the promissory Note and be immediately payable.

9. On default under the promissory Note or this agreement, or any other security device or obligation affecting the Note or this agreement, Creditor may call the Note due.

10. On default, Creditor has all the remedies of a secured party under the California Commercial Code.

I agree to the terms stated above.

Debtor's Name: _________________________________

Address: _____________________________________

____

Debtor's Signature: ______________________________

Debtor's Signature: ______________________________

I agree to the terms stated above.

Creditor's Name: ________________________________

Address: ______________________________________

____

Creditor's Signature: _____________________________

Creditor's Signature: _____________________________

Thus, in a real estate transaction, the buyer and carryback seller or lender demonstrate their intent to treat an item as personal property, not a real estate fixture, by securing the item under a security agreement and filing a UCC-1 Financing Statement (UCC-1) to perfect the seller's security interest.

*Editor's note — The parties' intent as to whether an item is personal property or a fixture does not control for property assessment purposes. [**Kaiser Co.** v. **Reid** (1947) 30 C2d 610]*

Personal property secures the carryback

Consider a broker who advises a seller of an apartment complex to additionally secure his carryback note with the furnishings, refrigerators and maintenance equipment included in the purchase price.

Unless the personal property sold as part of an installment sale is security for the debt owed the seller, the buyer may sell the personal property at his whim. The buyer becomes the owner of the personal property, unencumbered by the debt owed the carryback seller unless the seller is granted a security interest in the personal property.

More importantly, if the personal property sold is not included with the real estate as additional security for the carryback note, the seller can foreclose only on the real estate and the personal property cannot be repossessed. [**C.B. Cunningham** v. **Security Title Insurance Co.** (1966) 241 CA2d 626]

However, even if the note is additionally secured by personal property sold in what is primarily a real estate transaction, the buyer has no personal liability on the carryback note for any deficiencies on a foreclosure. [Calif. Code of Civil Procedure §580b]

Documenting a perfected security interest

Three documents are required to properly structure a sale or loan transaction on the sale of real estate which is to include personal property as additional security for a debt:

- a **promissory note** [See Form 420 in Chapter 5];
- a **security agreement** [See Form 436 accompanying this chapter]; and
- a **UCC-1 Financing Statement**. [See UCC-1 Financing Statement accompanying this chapter]

To process a sale involving personal property, a *bill of sale* is prepared by escrow and executed by the seller. A **bill of sale** transfers ownership of the personal property to the buyer, just as a grant deed conveys the ownership of real estate. [See **first tuesday** Form 408]

The *promissory note* evidences the buyer's obligation to pay the debt created by the installment sale or loan.

The debt can be evidenced by one note and secured by both the real estate using a trust deed and the personal property using a UCC-1 in what is called a *mixed collateral transaction*.

Alternatively, when a carryback note or loan is to be secured by both real estate and personal property, the carryback seller or lender and the buyer can agree to divide the debt into two separate debts, each evidenced by a note — one debt secured by real estate and the other debt secured by personal property.

[redacted]

UCC FINANCING STATEMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGEMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (1a or 1b) – do not abbreviate or combine names

1a. ORGANIZATION'S NAME				
OR 1b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
1c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY
[redacted] ADD'L INFO RE ORGANIZATION DEBTOR / 1e. TYPE OF ORGANIZATION	1f. JURISDICTION OF ORGANIZATION	1g. ORGANIZATIONAL ID#, if any		NONE

2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (2a or 2b) – do not abbreviate or combine names

2a. ORGANIZATION'S NAME				
OR 2b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
2c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY
[redacted] ADD'L INFO RE ORGANIZATION DEBTOR / 2e. TYPE OF ORGANIZATION	2f. JURISDICTION OF ORGANIZATION	2g. ORGANIZATIONAL ID#, if any		NONE

3. SECURED PARTY'S NAME (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) – insert only one secured party name (3a or 3b)

3a. ORGANIZATION'S NAME				
OR 3b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
3c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

4. This FINANCING STATEMENT covers the following collateral:

5. ALTERNATIVE DESIGNATION [if applicable]: ☐ LESSEE/LESSOR ☐ CONSIGNEE/CONSIGNOR ☐ BAILEE/BAILOR ☐ SELLER/BUYER ☐ AG. LIEN ☐ NON-UCC FILING

6. ☐ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum [if applicable]

7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [ADDITIONAL FEE] [optional] ☐ All Debtors ☐ Debtor 1 ☐ Debtor 2

8. OPTIONAL FILER REFERENCE DATA

FILING OFFICE COPY – NATIONAL UCC FINANCING STATEMENT (FORM UCC1) – CALIFORNIA (REV. 01/01/08)

If two separately secured debts are created, both the trust deed and the security agreement can contain a cross-collateral provision stating a default in one of the debts is a default in both debts, called a *dragnet clause*. [**Wong** v. **Beneficial Savings and Loan Association** (1976) 56 CA3d 286; see Chapter 14]

The security agreement

A security agreement creates a **lien on personal property** and is the personal property counterpart to a trust deed used as a security device to impose a lien on real estate.

The security agreement contains the rights and obligations of the parties regarding the secured personal property, including protection against waste, remedies on default and transfer provisions. [See Form 436]

The security agreement is retained by the carryback seller or lender and not recorded with any agency.

To create an enforceable security interest in personal property, the **security agreement** must:

- identify the debt or other obligation for which the personal property is security, typically evidenced by a note;
- describe the personal property which is the security; and
- grant a security interest in the personal property from the buyer or borrower to the carryback seller or lender. [**Needle** v. **Lasco Industries, Inc.** (1970) 10 CA3d 1105]

An enforceable security interest or lien will **attach** to personal property if:

- the borrower or buyer signs and delivers a security agreement containing a description of the personal property;
- the borrower or buyer has ownership rights in the personal property, as are received under a bill of sale; and
- value is given in exchange for the security interest, such as an installment sale by a seller or a loan made by a lender. [Com C §9203(b)(3)]

If the personal property consists of **standing timber** or **unharvested crops** which the buyer intends to remove, the security agreement must also include a description of the real estate on which the personal property is located. [Com C §9203(b)]

A security agreement used to create a lien on **oil, gas or minerals** before they are extracted must also contain a description of the real estate on which the natural resources are located.

The recorded UCC-1 perfects the lien

A **security agreement**, unlike a trust deed, is not recorded. Thus, the agreement used to create the lien on personal property is not the document used to *perfect* the carryback seller's or lender's security interest in personal property against future claims or transfers of that personal property. [Com C §9308]

To **perfect a lien** on personal property against later claims acquired by others, a separate security device entitled the *UCC Financing Statement* (UCC-1), is prepared and filed with the Secretary of State, or the local county recorder depending on the type of property. [Com C §§9310, 9501]

The UCC-1 Financing Statement, UCC-2 Change Form and UCC-3 Request for Information Form may be downloaded from the Secretary of State's website at: http://www.ss.ca.gov.

The UCC-1 is a **statutory form** which contains information about:

- the lender, called the *secured party*;
- the borrower, called the *debtor*;
- a description of the personal property, called *collateral*; and
- a description of the real estate where the personal property is located. [Com C §§9502, 9503]

Additionally, a UCC-1 which describes timber, oil, gas, minerals or unharvested crops as the security for a debt must also contain:

- a description of the real estate, similar to the description used in a trust deed;
- a statement the UCC-1 will be recorded with the local county recorder; and
- the name of the owner of the described real estate, if the owner is not the borrower. [Com C §§9502, 9503]

A lender or carryback seller secured by personal property must file a UCC-1 to put all parties who later acquire an interest in the secured property on notice of the lender's or carryback seller's priority interest.

If the lender or carryback seller secured by personal property fails to file a UCC-1, they run the risk of their lien being wiped out should the borrower or buyer sell or encumber the property or file a bankruptcy petition.

Without the filing of a UCC-1, a later buyer or creditor will not have *constructive notice* of the lender's unperfected security interest in the personal property. [Com C §9317]

Filing requirements

In most cases, the UCC-1 Financing Statement (UCC-1) is filed with the Secretary of State to perfect a lien on personal property as agreed to in a security agreement. [Com C §9501(b)]

If the UCC-1 covers standing timber, oil, gas, minerals or unharvested crops it is recorded in the county in which the described real estate is located, usually concurrent with any trust deed recorded against the real estate. [Com C §9501(a)(1)]

A **search for liens** on personal property is initiated by filing a *UCC-3 Request for Information* (UCC-3) with the Secretary of State. The response from the Secretary of State to the UCC-3 request is comparable to a title search on real estate. [Com C §9523]

Editor's note — Before closing a sale involving personal property items, the broker should have escrow file a UCC-3 with the Secretary of State or the county recorder to obtain a lien report to assure the personal property is unencumbered.

Real estate sold with personal property

Several types of real estate when sold typically include the sale of personal property, such as:

- apartment complexes;
- office buildings;
- vacation homes;
- business opportunities;
- hotels or motels;
- farms or timberland;
- oil, gas or minerals; and
- mobilehome spaces.

The sale of apartment complexes and office buildings typically include the sale of furniture, maintenance equipment, computer systems and trade fixtures.

Vacation homes are often sold fully furnished for recreational uses. Thus, the sale of the vacation home might include everything from furniture and snow clearing equipment to linens and kitchenwares.

Sale of a business opportunity

The sale of a business consists of the transfer of personal property assets — goodwill, equipment, trade fixtures, receivables, and inventory — together with the transfer of the real estate interest held in the premises occupied by the business, whether fee simple or leasehold.

Usually, the sale of a business opportunity includes a leasehold interest in the real estate occupied by the business. Thus, the sale involves an **assignment** of the existing lease or a subletting.

The seller of a business located on leased property, in addition to filing a UCC-1 to secure the carryback note, obtains and records a trust deed executed by the buyer describing the leasehold under which the business occupies the premises. A lease of the premises is an interest in real estate, and is not personal property requiring use of a UCC Financing Statement (UCC-1). [CC §761]

A UCC-1 is not the proper document to be used to perfect a lien on a leasehold interest in real estate. [**Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25]

However, when a UCC-1 is used to describe real estate as the property liened, a mortgage on the real estate is created which must be judicially foreclosed, unless a power-of-sale provision is included in the UCC-1 or security agreement.

Thus, a trust deed with a power-of-sale provision is preferable to a UCC-1 for creating liens on any interest in real estate. Security interests in leases on real estate are governed by real estate mortgage law, not the commercial codes which govern personal property liens.

The sale of hotels and motels

The sale of hotels, motels and boarding houses involves substantial amounts of personal property, such as furniture, trade fixtures, appliances, maintenance and kitchen equipment, as well as future *revenues* from the rooms, restaurants and shops owned and located on the premises.

Income from **room revenue** is classified as rent. Rent is recoverable by a secured creditor under an assignment of rents provision as contained in most trust deed forms.

Rent from real estate, even if generated by a hotel, is not considered business income and thus is not subject to UCC rules governing personal property security. [**In re Days California Riverside Limited Partnership** (9th Cir. 1994) 27 F3d 374]

Editor's note — To include the hotel's ***rental income*** *as security for the carryback note, the seller includes an assignment of rents provision in the trust deed carried back on the sale. An assignment of rents provision allows the lender or carryback seller to collect the rental income from a hotel, motel or any other type of income-producing building on the owner's default. [See Chapter 17]*

However, income from other services rendered by the hotel or motel owner, such as food and beverage sales, are liened by a security agreement and perfected by filing a UCC-1. [In re Days California Riverside Limited Partnership, *supra*; Com C §9102(a)(2)]

Sale of a farm or timberland

The sale of a farm involves personal property such as equipment, livestock, unborn livestock, and unharvested crops, all of which can be security for a debt. [Com C §9102(a)(34),(44)]

Although plants and trees are considered real estate until severed from the land, unharvested crops, also called *future crops*, and standing timber may be sold or encumbered as personal property, separate from the real estate, with a security agreement and a UCC Financing Statement (UCC-1). [Com C §9102(a)(34), (44)]

UCC-1 extension

The UCC-1 Financing Statement (UCC-1) is effective for **five years** after it is filed. [Com C §9515(a)]

To **prevent expiration** of the UCC-1 and retain priority, the lender must file a continuation statement, called a *UCC-2 Change Form*, with the Secretary of State or county recorder within the six month period before expiration.

The UCC-2 must identify the original UCC-1 and be signed by the lender or carryback seller. [Com C §9515(c), (d)]

Any number of later continuations may be filed, simply by repeating the process every five years. [Com C §9515(e)]

The fee for filing either an original UCC-1 or a continuation on a standard form prescribed by the Secretary of State, is $10. The filing fee for a nonstandard UCC-1 form is $20. [Calif. Government Code §12194]

SECTION D

Carryback Financing

Chapter 25 Carryback financing in lieu of cash

This chapter introduces the concept of carryback financing and presents the various forms of documentation and risks of loss involved.

Seller financing supports the price

Most real estate sales involve the financing of some portion of the purchase price. During economic periods of plentiful and inexpensive mortgage money, the financing needed to fund the purchase of real estate is provided by an institutional or private lender, or more likely a mortgage banker.

However, when **economic conditions** tighten and reduce the availability of real estate loans to previously qualified buyers, a seller hoping to sell his property – and maintain his asking price must consider financing the purchase himself if he is to obtain a buyer.

Seller financing, also called an *installment sale* or *credit sale*, involves carrying back a note for the unpaid portion of the price remaining after deducting the down payment and the amount of the loan the buyer is assuming. Under most circumstances, the note will be secured by a first if the property is free of trust deed liens, or a second trust deed on the property being sold.

Thus, the carryback seller takes a secured creditor's position in the property for the amount of the price remaining to be paid, comparable to that of a mortgage lender. On closing, the legal rights and obligations of real estate ownership previously held by the buyer are shifted by the transfer to the buyer, while the seller carrying back a note and trust deed takes on the rights and obligations of a secured creditor.

Carryback financing offers considerable financial and tax advantages for both buyers and sellers of real estate when the installment sales transaction is properly structured.

The seller who offers a convenient and flexible financing package to prospective buyers makes his property more marketable and defers the tax bite on his profits. Qualified buyers who are rational are always willing to pay a higher price for real estate when attractive financing is available, regardless of whether it is provided by the seller or a mortgage lender.

Even the most qualified buyer will agree to a higher price when he can defer payment of the price through financing provided by the seller. This is especially true when the rate of interest on the carryback financing is competitive or below the rates lenders are charging on their purchase-assist loans, or when market prices (and rents) are trending upward which is economically equivalent to reducing the fixed rate of interest paid to the seller. [See Chapter 55]

Tax benefits and flexible sales terms

Taxwise, it may be preferable for the seller to carry back a portion of the sales price, rather than be cashed-out on the sale. The seller taking a significant profit on a sale will be able to defer a meaningful amount of profit taxes, spreading the payment of profit taxes over a period of years. Thus, he avoids a premature tax bite in the year of the sale on his non-exempt transaction. [See Chapter 54]

Finally, the seller needs to understand the tax impact he will receive on his carryback financing is *portfolio category income*, without concern that the property sold was in another income category (passive/

business/personal). The seller converts his real estate equity into a note which generates a constant cash flow. Otherwise he is cashed-out of his equity, pays profit taxes (unless exempt – §1031 – or *excluded* – principal residence) and reinvests what remains of his diminished after-tax sales proceeds.

The carryback note, in a rising market, typically provides for a higher interest yield than is available on other investments with a similar level of risk. The converse is true in a recessionary market. Additionally, the seller has first hand knowledge about his security – the property he is selling.

For buyers, seller carryback financing is a situation that generally offers a moderate down payment, competitive interest rates, less stringent terms for qualification than those imposed by lenders and no origination (hassle) costs.

Mortgage lenders typically require a minimum down payment of 20% for the buyer to avoid the additional burden of qualifying for *private mortgage insurance* (PMI). In a carryback sale, the amount of the down payment is negotiable between the buyer and seller without outside influences, such as the requirements of the secondary mortgage market pools and PMI underwriters, which mortgage loan brokers and borrowers must contend with.

Also, the buyer is logically able to negotiate a lower-than-market interest rate in exchange for agreeing to the seller's higher-than-market asking price. The seller can have one or the other, but not both, if the buyer (or the buyer's broker) is knowledgeable and everyone involved is rational.

Variations on carryback financing

Seller financing is documented in a variety of ways, including land sales contracts, lease-option sales, sale-leasebacks and trust deed notes. [See Chapter 35]

Legally, the note and trust deed is the most certain, as well as the most universally understood, of the various documents for structuring seller financing. Importantly, the note and trust deed are combined to evidence the debt owed the seller and provide security for repayment on the seller's grant deed conveyance. The **carryback documentation** consists of:

- a **promissory note** executed by the buyer in favor of the seller as evidence that a portion of the price remains to be paid for the real estate; and

- a **trust deed lien** on the property sold to secure the debt owed by the buyer as evidenced by the note.

The promissory note states the exact amount and terms for repayment of the debt the buyer owes to the seller. On the other hand, the trust deed creates a lien on the property which acts as security for payment of the debt. The trust deed requires the buyer to maintain the secured property, and gives the seller the power to foreclose through a trustee's sale should the buyer default on note payments or trust deed conditions.

The note and trust deed can be structured in regular or all-inclusive terms to meet the financial needs of the buyer and seller.

For instance, if the real estate is encumbered by a first trust deed which a qualified buyer can **assume** with the lender, the seller can carry back a regular note secured by a second trust deed. The note will be for the balance of the **seller's equity** which remains unpaid after deducting the buyer's down payment.

However, if the lender or servicing agent for the existing loan will not allow the loan to be assumed by the buyer, the buyer might arrange a new first trust deed loan to pay off the existing financing. Here, the lender will need to approve of the seller carryback of a second trust deed. [See Chapter 28]

If the seller's borrowing power is greater than the buyer's, the seller might refinance the existing loan on the property himself and draw out a portion of his equity by placing new conventional financing on the property.

The buyer assumes the new loan and the seller carries back a regular note and junior trust deed for the remainder of his unpaid equity in the property.

Another alternative which reduces the seller's risk of loss and defers more profit taxes than a regular second trust deed note, is the all-inclusive trust deed (AITD) note, called a *wraparound security device*. In an AITD carryback arrangement, the amount owed the seller on the carryback note is always secured by a junior trust deed (AITD) lien on the property. However, the note secured by the AITD is for a dollar amount equal to the balance of the entire purchase price remaining unpaid after the down payment, and is not a regular note limited to the amount of equity remaining unpaid after the down payment. [See Chapter 32]

Thus, the AITD "wraps" the senior financing by including the dollar amount of the first trust deed in the principal amount of the AITD note. The buyer makes payments to the seller on the AITD note. In turn, the seller continues to remain responsible for making payments on the senior loan from payments received on the AITD. [See Chapter 32]

Carryback risks for the seller

A carryback seller must be aware he takes on the **role of a lender** in a carryback sale, with all the risks and obligations of a lender holding the seller's secured position. [See Chapter 35]

Above all, the seller must be willing to accept the **risk of loss on a default** by the buyer in payments on the note or provisions in the trust deed. A seller who forecloses in an effort to recover the amounts owed on the carryback note from the property's value will be forced to advance cash to make payments on the senior trust deed loan. Also, a risk of loss due to impairment of the security exists, allowing for foreclosure, should the buyer default on trust deed provisions for the payment of taxes, assessments and insurance premiums. [See Chapter 16]

Costs incurred in foreclosing and reselling the property can quickly turn a low-downpayment, high-interest-rate sale into a cash drain for the seller. [See Chapter 35]

Also, the seller must understand a carryback note is *nonrecourse paper*. Thus, the seller will be barred from obtaining a money judgment from the buyer for any part of the carryback debt not satisfied by the value of the property – the deficiency. [Calif. Code of Civil Procedure §580b]

On a default by the buyer, the carryback seller could suddenly find himself returned to his original position — owning property he no longer wanted to own and still subject to the senior trust deed. Further, the seller will incur out-of-pocket costs for:

- foreclosure;
- carrying the property;

- any reduction in property value or property taxes for reassessment;

- a modified (higher) interest rate on the old loan (foreclosure triggers the due-on clause); and

- profit taxes on any previously untaxed principal in the down payment.

As with any creditor, if the **risk premium** built into the price, down payment and interest rate on the carryback note is sufficient, the benefits of carryback financing outweigh the risks of loss.

Chapter 26 The carryback purchase agreement

This chapter discusses an agent's use of installment sale provisions in a purchase agreement to negotiate the financing of a sale by the seller carrying back a note and trust deed.

Negotiating the terms for seller financing

A buyer contacts a real estate agent to assist him to locate and purchase real estate. The agent obtains information about the buyer's financial status and general description of the real estate to be located and the terms of its purchase — price and financing — preferred by the buyer.

The buyer is able to make a down payment of $100,000 and is prequalified to originate or assume a loan up to $1,100,000.

Before the agent begins to locate suitable property, the buyer is presented with a fully prepared **Buyer's Listing Agreement** for review with the agent and signatures. The agent explains the written retainer agreement is a requisite to his receiving full recognition from other brokers and agents of the existence of his agency relationship with the buyer. When authorized by a listing to act on behalf of the buyer, brokers and agents readily provide information (disclosures) on their listed properties for analysis by his buyer. [See **first tuesday** Form 103]

The buyer enters into the **Buyer's Listing Agreement**, obligating the agent's broker and the agent to work diligently to locate property on behalf of the buyer in exchange for receiving an enforceable fee arrangement. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

Later, the agent locates a property he believes meets the financial objectives and preferences of the buyer.

The listed sales price for the property is $1,100,000. After the agent's cursory review of the property's features with the buyer, the buyer indicates he wants more information about the conditions of the property. The agent gathers up all the basic property disclosures from the seller's listing agent so the buyer can make a decide whether to make an offer, and if so, on what terms and conditions.

After receiving and reviewing the seller's property disclosures, but before discussing the condition of the property and the terms of purchase with his buyer, the real estate agent prepares a purchase agreement. The proposed offer takes into consideration the buyer's financial condition and expectations known to the agent as a result of their prior discussions, called *counseling*. The buyer is not risk averse.

Having considered and prepared the purchase offer he will propose, the agent is ready to discuss with the buyer the merits and reasons for entering into the proposed offer. Together, the buyer and agent will mold the final purchase offer which will be signed and submitted to the seller. [See Figure 1]

Installment sale provisions

The agent, on investigation, learns the seller received one offer since he listed the property. It was a cash-out offer for $850,000, but called for the seller to pay all the buyer's nonrecurring financing charges and closing costs. The seller countered at $900,000, calling for the buyer to pay his own costs and charges. The buyer rejected the counter offer and withdrew from further negotiations with the seller.

The property is encumbered with an existing trust deed loan of $450,000, at a 6.5% fixed rate of interest, payable monthly, until paid, with 25 years remaining. The listing agent failed to include the financing in the MLS data on the property, but supplied it on request.

Interest charged on a new loan is currently at a *note rate* of 7.25%, whether fixed or variable. Thus, the difference in payments between the existing loan and a new loan is nearly $2,000 in annual savings, comprised entirely of interest.

The buyer's agent recommends that the buyer offer the seller $900,000, the amount of the seller's all-cash counter offer to the previous buyer. The agent informs the buyer of his belief that the cash value of the property is probably less than $900,000, but notes that sellers typically resist trends in weakening prices, causing prices to be "sticky" in deteriorating markets in spite of fewer prospective buyers.

The terms suggested by the agent include savings due to monthly payments and interest rate charges for a new loan, greater loan reduction (amortization), and avoidance of new loan costs, as well as reducing the seller's closing costs by avoiding a prepayment penalty on a payoff of his loan. The buyer's savings over the first five years of ownership would be approximately $36,000, which would effectively place a **present worth** on the property of less then a $900,000 cash offer.

The terms proposed by the buyer's agent for payment of the $900,000 price includes:

- a down payment of $100,000 in cash;
- a takeover of the $450,000 existing loan on the property; and
- a note for $350,000 executed by the buyer in favor of the seller, secured by a trust deed carried back on the property.

The terms for payment of the $350,000 carryback note include:

- interest greater than 4.5% the note's Applicable Federal Rate (APR) for imputing interest;
- a monthly payment (a 17 year, 10 months amortization schedule); and
- a final/balloon payment, due ten years after the close of escrow.

The agent prepares a worksheet to document the savings of $102,835.66 the buyer will realize over the first five years of ownership under the proposed carryback transaction, which include:

- $38,686.17 on the takeover of the existing $450,000 loan at 5.5% versus the current market rate of 7.25% on that amount (both amortized over 25 years). This amount includes a savings in monthly

payments over five years of $28,878.46 due to the differences in the dollar amount of payments ($2,750.79 versus $3,233.10, a $482.31 monthly saving), and additional principal reduction over five years of $9,807.71 ($401,712.86 at 5.5% versus $411,529.57 at 7.25%);

- $52,149.85 as the additional principal reduction over five years on the amortization of the $350,000 carryback at 4.5% ($278,175.87) versus current market rates of 7.25% ($330,325.72). This calculation is based on retaining the amount of the monthly payment set by a 30-year amortization at current 7.25% market rates ($2,373.28) as the monthly payment on the 4.5% carryback (amortizing the carryback over 17 years and ten months); and

- $12,000 (approximate) savings by avoiding the costs of originating a $800,000 purchase-assist loan with its costs, charges, discounts, fees, points, lender's title policy, etc.

The existing trust deed contains a due-on clause as disclosed by the trust deed accompanying the **property profile** the agent ordered out from the title company. The listing agent had not ordered a copy. On any take over of an existing loan, the lender has the right to call or demand a recast of the terms for payment of the note.

As a result of the discussion, a provision is added to the purchase agreement calling for the seller to enter into a *subordination agreement*. The buyer will need this arrangement if the lender calls the loan, or demands a loan modification or an early payoff. If a payoff is required, the property will need to be refinanced to borrow sufficient funds to pay off the demand on the existing first trust deed and cover the refinancing charges.

Should the lender call the loan or demand a modification, the seller will need to cooperate by entering into a specific **subordination agreement** at the time of the loan modification or recording of the refinancing. To be assured the seller will cooperate, he must sign an agreement consenting to the future subordination of the carryback trust deed on a modification or refinance of the first trust deed. [See **first tuesday** Form 281]

Adjustments on closing for any difference between the amount of the balance on the existing loan at closing and as stated in the purchase agreement will be made into the principal amount of the carryback note. No adjustments will be made in the price or downpayment amounts. [See Figure 1 §5.1]

Required financing disclosures

The agent preparing a carryback offer must disclose to both the buyer and seller the various financial and legal features which would influence prudent sellers and buyers in a carryback transaction. For offers involving four-or-less residential units, the minimum carryback financing disclosures are **mandated by statute**, other property disclosures are imposed by case law. [See Form 300 in Chapter 29]

A statutory **Carryback Disclosure Statement** on a credit sale of a one-to-four unit residential property is intended to be prepared and attached to the purchase agreement as an addendum. If it is not included with the purchase agreement, a statutory contingency is triggered, giving the buyer the right to cancel the transaction until the disclosure form is signed by the buyer and the seller. [See Chapter 29]

After the purchase agreement prepared by the agent is signed by the buyer, it will be submitted to the seller as an offer to buy. The seller will then consider whether to accept the offer, counter with another offer, or reject it without a counter offer.

Figure 1 *Excerpt from **first tuesday** Form 150 – Purchase Agreement*

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of . . . . $_______________

3.1 Other consideration paid through escrow _________________________________ . . . $_______________

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . $_______________
payable approximately $_______________ monthly for a period of ______ years.
Interest on closing not to exceed ______%, ☐ ARM, type _______________________.
Loan points not to exceed _____________.

4.1 ☐ Unless Buyer, within ______ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **ft** Form 183]

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by ____ with an unpaid principal balance of . . . . $_______________
payable $_______________ monthly, including interest not exceeding _____%,
☐ ARM, type _________________________, plus a monthly tax/insurance impound payment of $______________. ____

5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.

5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.

6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ____ with an unpaid principal balance of . . . $_______________
payable $_______________ monthly, including interest not exceeding ______%,
☐ ARM, type _________________________, due _____________, 20 ______.

7. Assume a tax bond or assessment lien with an unpaid principal balance of . . . . $_______________

8. Note for the balance of the purchase price in the amount of. . . . . $_______________
to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due _______________ years after closing.

8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ ______________.

8.2 A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]

8.3 Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

8.4 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

8.5 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **ft** Form 183]

8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **ft** Form 436]

9. Total Purchase Price is . . . . $_______________

Analyzing the purchase agreement

The conventional purchase agreement, **first tuesday** Form 150, is used to prepare and submit the buyer's **written offer** to purchase one-to-four unit residential property. Terms for payment of the price are limited to conventional financing, an assumption of existing loans and a carryback note. Form 150 is also properly used by sellers in a counteroffer situation to submit their **fresh offer** to sell the real estate.

The purchase agreement offer, if accepted, becomes the binding written contract between the buyer and seller. Its terms must be complete and clear to prevent misunderstandings so the agreement can be judicially enforced. Thus, Form 150 is a comprehensive "boilerplate" purchase agreement which serves as a **checklist**, presenting the various conventional financing arrangements and conditions a prudent buyer would consider when making an offer to purchase.

Preparing the purchase agreement

The following instructions are for the preparation and use of the Purchase Agreement – One-to-Four Residential Units, **first tuesday** Form 150. Form 150 is designed as a checklist of practical provisions so a broker or his agent can prepare an offer for a prospective buyer who seeks to purchase conventionally financed, one-to-four unit residential property located in California. [See Figure 1]

The numbers on the instructions correspond to the numbers given provisions in the form.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Terms for payment of the purchase price:

3. *Cash down payment*: **Enter** the dollar amount of the buyer's cash down payment toward the purchase price.

    3.1 *Additional down payment*: **Enter** the description of any other consideration to be paid as part of the price, such as trust deed notes, personal property or real estate equities (an exchange). **Enter** the dollar amount of its value.

4. *New trust deed loan*: **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed loan. **Enter** the amount of the loan, the monthly principal and interest (PI) payment, the term of the loan and the rate of interest. **Check** the box to indicate whether the interest will be adjustable (ARM), and if so, **enter** the index name. **Enter** any limitations on loan points.

    4.1 *Buyer's loan qualification*: **Check** the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new loan and fails to deliver documentation from a lender indicating he has been qualified for a loan. **Enter** the number of days the buyer has after acceptance to deliver written confirmation of his qualification for the loan.

5. *First trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing first trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment. **Enter** any due date or other terms unique to the loan.

    5.1 *Loan balance adjustments*: **Check** the appropriate box to indicate the financial adjustment desired for loan balance differences at the close of escrow.

    5.2 *Impound balances*: **Check** the appropriate box to indicate whether the impound account transferred to the buyer will be with or without a charge to the buyer.

6. *Second trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing second trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** the due date for payment of a final/balloon payment.

7. *Bond or assessment assumed*: **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos or 1915 improvement bonds) which will remain unpaid and become the responsibility of the buyer on closing.

Editor's note — Improvement bonds are obligations of the seller which may be assumed by the buyer in lieu of their payoff by the seller. If assumed, the bonded indebtedness becomes part of the consideration paid for the property. Some purchase agreements erroneously place these bonds under "property tax" as though they were ***ad valorem taxes****, and then fail to prorate and charge the unpaid amount to the seller.*

8. *Seller carryback note*: **Enter** the amount of the carryback note to be executed by the buyer as partial payment of the price. **Enter** the amount of the note's monthly PI payment, the interest rate and the due date for the final/balloon payment.

   8.1 *Special carryback provisions:* **Check** the appropriate box to indicate any special provisions to be included in the carryback note or trust deed. **Enter** the name of any other special provision to be included in the carryback note or trust deed, such as impounds, discount options, extension provisions, guarantee arrangements or right of first refusal on the sale or hypothecation of the note.

   8.2 *Carryback disclosure:* **Fill out** and **attach** a Seller Carryback Disclosure Statement as an addendum. [See Form 300 in Chapter 29]

Editor's note — Further approval of the disclosure statement in escrow creates by statute a buyer's contingency allowing for cancellation until time of closing on any purchase of one-to-four unit residential property.

   8.3 *Notice of Delinquency:* **Requires** the buyer to execute a Request for Notice of Default and Notice of Delinquency and pay the costs of recording and serving it on senior lenders since they will have priority on title to the trust deed securing the carryback note. [See Form 412 in Chapter 48]

   8.4 *Buyer creditworthiness*: **Requires** the buyer to provide the seller with a completed credit application. [See Form 302 in Chapter 31]

   8.5 *Approval of creditworthiness*: **Enter** the number of days within which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

   8.6 *Subordination*: **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a trust deed loan with priority on title to the carryback note are exceeded. [See **first tuesday** Form 183]

   8.7 *Personal property as security*: **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 financing statement to provide additional security for any carryback note. [See Form 436 in Chapter 24]

9. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

Chapter 27 No down payment carryback sales

This chapter explores the seller's financial risks in an installment sale structured with little to no cash down payment.

Minimizing the risks of default

A couple decides to purchase income producing property to begin a long-term real estate investment program as an alternative to holding shares in businesses to develop wealth for the family.

Each spouse earns a significant annual income, with a combined discretionary disposable income in excess of $125,000 annually which they are prepared to commit to real estate investments.

In the past, the couple spent most of their disposable income on the costs of high living. Consequently, they have accumulated insufficient cash savings for a meaningful down payment on a purchase.

Despite their lack of substantial savings, the couple's large stable income enables them to make significant additional monthly or quarterly principal payments to pay for property they acquire, called a *deferred down payment* plan. Thus, the couple is willing to subject themselves to a self-enforcing savings program by committing themselves to **build up equity** in real estate through debt reduction.

The periodic installments of principal only will be in addition to the regular monthly payments. For the seller, the extra principal payments are rationally viewed as the **deferral** of a cash down payment.

The additional principal payments will be made during the first year or two following the purchase of the property. With the couple's $125,000 in excess annual income to invest, they have the capacity to pay a seller at least an additional $200,000 in principal over a two-year period.

At their agent's suggestion, the couple signs a purchase agreement offer on an income producing property which they have determined is financially suitable, on following the terms:

- the purchase price to be $1,500,000;
- no cash down payment to be made;
- the buyer to pay all closing costs;
- a note and trust deed to executed by the buyer in favor of the seller for the entire amount of the seller's equity in the property;
- the note interest rate to be the rate currently charged on mortgages;
- monthly payments to be based on a 30-year amortization;
- eight (8) equal quarterly payments of principal to be due on the note totalling $200,000 over two years; and

- a 10-year due date for a final/balloon payment.

Attached to the offer is the carryback disclosure statement prepared by the buyer's agent. [See Form 300 in Chapter 29]

The buyer's agent delivers the offer to the listing agent. Together, they review the offer for presentation to the seller.

The risk of default and foreclosure

Before submitting an offer to the seller, the listing agent concludes the offer is probably unsuitable for his client as it stands.

Must the agent hand the no-down offer to the seller?

Yes! A listing agent, acting as his broker's agent, is duty bound to present all offers he receives, no matter what form they may take, even though he may consider an offer to be unsound or otherwise unacceptable to the client. [DRE Bulletin Fall 2001]

The listing agent, on submitting the offer to the seller, points out the carryback aspects of the offer which present additional legal and financial risks to the seller, including:

- the seller will not be cashed out since the net proceeds of the sale will be in the form of a note — thus, the seller should receive either a higher-than-market interest rate or a higher-than-market price for his property to compensate for the risk of loss he would avoid on an all-cash sale [**Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860];

- the carryback note is *purchase money* paper — a nonrecourse debt — so if the buyer does default, the seller's only remedy is to foreclose on the property since a money judgment is not allowed on a nonrecourse note [Calif. Code of Civil Procedure §580b]; and

- without a down payment, cash proceeds from the sale will not exist to absorb the out-of-pocket cash costs to foreclose should the couple default on the carryback note.

For the property to support the financial burdens imposed on the carryback seller by a foreclosure, an equity of no less than 10% to 15% must exist above the seller's carryback trust deed note. Without a cash down payment large enough to generate net cash proceeds to the seller on closing, the buyer has no equity in the property at the time of closing.

To demonstrate the financial risk facing the seller should he ever have to recover the property on a buyer's default, the listing agent prepares a **Carryback Foreclosure Cost Sheet** for review with the seller. On the cost sheet, the agent estimates the costs the seller will incur during a foreclosure and later resale of the property. The seller can use the disclosure to estimate the cash reserves he will need if he has to foreclose on the property. [See Chapter 30]

Also, the listing agent prepares a carryback disclosure statement on a form designed to comply with mandatory financial and legal disclosures on one-to-four unit residential properties, which this income producing property is not but to which the disclosures fully apply. [See Form 300 in Chapter 29]

Presenting the offer with advice

When presenting an offer, a listing agent's duty owed to the seller to care for and protect the seller in a transaction requires the agent to disclose all aspects of the proposed transaction which are *known or readily available* to the agent and might affect a prudent seller's decision to accept or reject the offer, such as:

- the **legal aspects** of carrying paper since the seller takes on the rights and obligations of a mortgage lender [Calif. Civil Code §2956];
- the **tax aspects** of the profit and income reportable in an installment sale [Internal Revenue Code §453; see Chapter 32]; and
- the **financial suitability** for the seller of the risks of loss involved in carrying paper. [Timmsen, *supra*]

Instead of accepting the offer or returning the offer as rejected, the listing agent suggests a counteroffer to re-structure the transaction so it will be financially suitable for the seller.

One hundred percent carryback financing on a little to no downpayment transaction provides benefits for a seller.

A seller may be motivated to accept a no-down offer by his desire to:

- increase his ability to sell the property at the price sought;
- receive a flow of interest income; and
- defer profit tax reporting on the sale until the principal is paid.

The seller who is able to provide carryback financing can sell his property more readily if the property is not aggressively (properly) priced to sell for cash. Buyers often do not have, or want to use, cash funds for a down payment. Also, buyers are typically more interested in acquiring property if the seller provides the purchase-assist financing needed to buy the property. Since carryback financing allows the buyer and seller to handle all the financing of the sale without the hassle and expense of arranging new financing with an institutional lender or mortgage banker.

The seller contemplating a no-downpayment transaction may be motivated by tax considerations, including:

- without a down payment, no profit will be reported in the year of sale except for any profit in the principal paid with the monthly payments;
- no debt relief will occur to trigger profit tax in the year of the sale, unless a mortgage exists with a balance which exceeds his remaining cost basis, in which case the seller will wrap it with an all-inclusive trust deed (AITD) note; and
- no profit will be reported in the carryback note until principal is paid, or the note is assigned in a sale or as collateral. [See Chapter 32]

Default and beyond

In a little to no downpayment carryback sale, the major legal and financial risk the carryback seller faces is a default by the buyer on the carryback note. A default and failure of a pre-foreclosure workout will force the seller to consider initiating foreclosure.

The sum of the combined amounts of the carryback note, underlying financing, the costs of foreclosure and resale are supported solely by the value of the property.

Thus, when sufficient downpayment funds have not been received to cover all these amounts, the seller commencing a foreclosure will have to use his own funds to pay the costs of foreclosure if he is to protect the value of his security interest in the property. Unless the **property value** rises, funds expended by the seller after a little to no down payment sale will not be recovered on a foreclosure and resale of the property.

No matter the amount of the down payment, a carryback seller must promptly start a pre-foreclosure workout or foreclosure proceedings on a default. The value of any equity securing the carryback note diminishes daily due to the accrual of property taxes, interest on underlying trust deed notes and property insurance premiums. Also, an actual decrease in the marketability, and thus the value of the property, occurs due to deferred maintenance and upkeep which often accompanies a default.

Even if the carryback seller immediately initiates the steps necessary to foreclosure on a default, completing a typical problem-free second trust deed **foreclosure and resale** of the property can easily consume cash funds equal to 15% of the property's value, paid approximately 50:50 from the seller's cash reserves and cash proceeds from a resale.

Minimizing the seller's risk of loss

All carryback sales involve some degree of risk of loss, as do all loans. However, a seller should not avoid a sale or a carryback note solely because a potential risk of loss exists.

The correct approach for the seller and his agent is to analyze the extent of the risk and take steps to **offset** and **cover the risk** by:

- reducing the degree of risk by a proportionately **larger down payment** sufficient in amount to cover the cost of foreclosure and resale;
- receiving a **premium** in the form of an increased price, a higher interest rate or greater principal reductions on the carryback note than provided by monthly amortization; or
- acquiring **additional security**, guarantees, letters of credit, etc.

The seller does not need to rely solely on the real estate sold to secure his carryback note in a no-down transaction. Through discussions and counteroffers, sellers negotiate with buyers for additional security acceptable to the seller. The additional security can be real estate or personal property, owned by the buyer or others.

Also, a carryback note becomes *recourse paper* when it is secured by property other than the property sold, or in addition to the property sold. With **recourse paper**, the seller may foreclose judicially and then pursue a money judgment against the buyer if the fair market value of the property securing the carryback note becomes insufficient to satisfy the seller's carryback note.

PROMISSORY NOTE — UNSECURED

DATE: ____________, 20_____, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. On or before ____________, 20_____, without a grace period, or ☐ on demand,

1.1 ____, as the Payor,

promises to pay to the order of:

1.2 ____, as the Payee,

address ____

1.3 the sum of $______________

2. Interest will be charged from Date at the rate of _____% per annum until paid.

3. Principal and interest will be payable in lawful money of the United States.

4. Should a default occur in payments when due, the entire sum of principal and interest will become immediately due at the option of the payee.

5. In any action to enforce this agreement, the prevailing party will receive attorney fees.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Signature of Payor: ____

Signature of Payor: ____

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Through a counteroffer, the carryback seller negotiates to include provisions such as:

- a **continuing guarantee** for the carryback note (guarantors are not protected by anti-deficiency laws as is the buyer who signed the note) [See Form 439 in Chapter 13];
- a **security interest** in personal property or other real estate, called *cross-collateralization* [See Form 436 in Chapter 24]; and
- the **carryback of an unsecured note** for part of the price (5% to 10% of the price). [See Form 424 accompanying this chapter]

The seller can negotiate to **cross-collateralize** the carryback note by securing it by both the property purchased and other property owned by the buyer (or other persons). Cross-collateralization by the buyer secures the carryback note by using **one trust deed** to describe multiple parcels of real estate as security for payment of the carryback note, called a *blanket trust deed*.

By carrying a **blanket trust deed** encumbering the property sold and other property, the seller is able to obtain a money judgment against the buyer when the combined market value of the properties on the date of a judicial foreclosure sale does not cover the balance due on the cross-collateralized carryback note. [CCP §580a, c]

The brokerage fee in a no-down deal

Payment of the brokerage fee is an additional concern for brokers and sellers involved in minimal or no down payment transactions.

The problem is not negotiating the amount of the fee, but how and when the broker will collect the fee in a cashless transaction, as occurs in a no-down sale or an exchange of equities (properties).

In cash sales, the fee is paid in cash by the seller on the close of escrow. When the sale or exchange includes little to no cash down payment and no new financing to generate cash funds, the broker, like the seller, must often wait to be paid.

Typically, the broker's fee in a carryback sale will be paid by the seller out of the first payments made by the buyer on the carryback note. Alternatively, the buyer can create a separate note for the amount of the broker's fee (and reduce the amount of the seller's carryback note by an equal amount), payable to the broker and secured by a junior trust deed on the property acquired. The purchase price for the real estate and transaction costs incurred by the buyer remain the same.

However, the broker must understand that a note signed by the buyer and secured by one-to-four unit residential property, purchased and occupied by the buyer, is **nonrecourse paper**. The note finances part of the purchase of the buyer's residence. [CCP §580b]

Thus, if the buyer defaults and an underlying trust deed holder (i.e., the seller) forecloses on the property, the broker's trust deed is wiped out, leaving the non-recourse note unsecured. Here, the broker cannot obtain a personal money judgment against the buyer/occupant of the one-to-four unit residential property. The broker simply loses his fee.

*Editor's note — This anti-deficiency rule only applies if the buyer purchases and occupies a one-to-four unit residential property. If the buyer does not occupy the property, or it is not one-to-four residential units, the broker can recover a money judgment for his unpaid services evidenced by the note previously secured by a wiped-out trust deed. [**Kistler** v. **Vasi** (1969) 71 C2d 261]*

The broker considering nonrecourse paper

To avoid being wiped out by the foreclosure of a senior trust deed, a broker may wish to avoid holding nonrecourse paper. Several options are available, for example:

- a seller can **guarantee** a buyer's junior trust deed note making the seller personally liable to the broker if a foreclosure wipes out the broker's security;
- the buyer or seller can provide property other than the real estate being sold as **additional or substitute security**;
- the broker can become a co-owner/beneficiary of a pro rata share of the carryback note;

- the broker can carry an unsecured recourse note, payable by the seller, or by the buyer as part of the price paid for the property; or

- the brokerage fee can be a recourse note signed by the seller and secured by a *collateral assignment* of the seller's carryback trust deed note. A security agreement would provide for all or part of the carryback payments to be received by the broker until the brokerage fee is paid in full. When the fee is fully paid, the broker will reassign the trust deed to the seller. [See **first tuesday** Forms 438 and 336]

However, the seller takes on an additional risk of loss under any arrangement in which he agrees to pay the deferred fee. The risk arises when the **buyer defaults** on payments and the carryback seller is required to foreclose on the property.

If the broker owns a percentage of the carryback, the carryback seller and the broker become partners in any foreclosure process. To avoid anarchy, they should enter into a co-ownership agreement as the beneficiaries of the trust deed before the closing of the sales escrow. Otherwise, on a foreclosure, they will have to find a way to cooperate as tenants-in-common (TIC) without the benefit of a previously written co-ownership agreement.

If the broker holds a note for the fee signed by the seller, collateralized or not by the seller's carryback note, the note for the fee is recourse/deficiency paper. The seller can be forced to pay — even when the carryback sale sours and the seller is faced with a loss — unless the note held by the broker provides for relief in the event the buyer defaults on the carryback note.

Chapter 28 — Due-on waiver and junior financing

This chapter comments on the need in a sale conditioned on the buyer assuming the existing lender's trust deed loan for a carryback seller to negotiate a waiver of the senior lender's due-on clause.

Prior planning prevents lender interference

A seller of real estate encumbered with a first trust deed lists the property for sale with his broker. The trust deed contains a due-on clause which is triggered by any sale.

Later, the listing broker presents his seller with a purchase offer from a buyer on terms which include:

- a cash down payment;
- an assumption of the existing first trust deed by the buyer; and
- a carryback note executed by the buyer in favor of the seller for the balance of the purchase price, secured by a second trust deed on the property.

Following negotiations and acceptance, a sales escrow is opened. As called for in escrow instructions, escrow requests a **loan assumption package** from the lender who holds the trust deed note.

Before the close of escrow, the lender approves the sale on a few conditions: the buyer is to **assume** the loan obligation and agree to a **modification** of the interest rate and payment schedule in the note.

Again, after further negotiations, the buyer agrees to the lender's demands and signs the loan assumption and note modification agreement. The lender does not enter into a written consent agreement with the seller regarding the carryback second trust deed. However, the lender did receive a copy of the purchase agreement and escrow instructions during the loan assumption process which discloses the carryback second trust deed as part of the sales transaction.

In this example, the lender consented to the conveyance of the secured property to the buyer on the terms of the sale as set out in the purchase agreement and sale escrow instructions the lender received. Thus, by its conduct, the lender has *waived* its rights under the due-on clause regarding the further encumbrance (second trust deed) carried back by the seller. The carryback is a separate event from the grant deed conveyance to the buyer, which itself triggers the due-on clause. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

However, the lender was not asked to and has not entered into a written agreement to waive its due-on right to **call or recast** the loan in the event that the buyer later transfers an interest in the property while the carryback seller still holds his second trust deed, or the seller forecloses and becomes the owner of the property again.

After the buyer takes title to the property, a transfer by the buyer of his interest in the secured real estate will require the lender's prior consent to avoid the risk of the lender calling the loan under the due-on clause. Exceptions include a lease with a term under three years and most non-sale principal residence transfers. [See Chapter 17]

On a later transfer of any interest in the property by the buyer, the lender has the right on each transfer to:

- **accelerate** (call) the balance of the loan; or

- **recast** the loan, demanding modifications of the note and a fee as a condition for allowing an assumption or other waiver of the due-on clause.

The trust deed lender can call the loan or demand the note to be recast, with exceptions for conveyance of the personal residence to family members or for an equity loan encumbrance on that residence, if, after escrow closes, the buyer:

- dies;

- conveys or further encumbers the property;

- enters into a long-term lease (over a three year term) or a lease with a purchase option; or

- defaults on the carryback note and the seller completes a foreclosure sale, etc. [See Chapter 17]

The written waiver

A typical carryback sales transaction is structured as either:

- a **regular** second trust deed and note carried back by the seller with the existing trust deed lender consenting to the conveyance of the property and the carryback trust deed by waiving its due-on clause in exchange for an assumption fee and modification of the note by the buyer; or

- an **all-inclusive trust deed** (AITD) and note, or another wraparound security device, with the underlying lender consenting to the conveyance to the buyer and the carryback AITD by waiving its due-on clause in exchange for a modification of the trust deed note and payment of fees by the seller — all in lieu of the buyer's assumption of the loan, an activity sometimes called a *reverse assumption*.

After the lender consents to the carryback sale and escrow closes, future events beyond the seller's control can again trigger the due-on clause.

A carryback seller, like any junior trust deed holder, must be made aware and understand a due-on clause in the existing trust deed gives the lender the absolute right to call the loan on a **future transfer of any interest** in the property by the buyer with only two restrictions. The lender's call is restricted only on short-term (up to three years) leases on any type of property, and on inter-family transfers and the further encumbrance of owner-occupied, four-or-less unit residential properties.

FURTHER ENCUMBRANCE CONSENT

DATE:_____________, 20______, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This consent agreement is entered into between

1.1 ____, as the Existing First Lender,
1.2 and ____, as the New Junior Lender,
1.3 regarding the Existing First Lender's trust deed recorded on _____________________________________,
as Instrument No._________________, in ______________________________ County Records, California,
1.4 executed by ____, as the Trustor,
1.5 in which ____ is named as the Beneficiary,
1.6 encumbering property referred to as ____
____.

2. A trust deed, junior and subordinate to the Existing First Lender's trust deed, will be executed in favor of the New Junior Lender in reliance on this consent agreement.

AGREEMENT:

3. The Existing First Lender hereby:

3.1 Consents to the further encumbrance of the property in favor of the New Junior Lender.

3.2 Waives its due-on rights until the New Junior Lender's trust deed encumbrance is reconveyed or foreclosed and no longer is a lien on the property.

3.3 Waives its due-on rights should the New Junior Lender later acquire title to the property by foreclosure or deed-in-lieu of foreclosure under its trust deed, subject to the following checked conditions at the time of transfer:

a. ☐ Payment of an assumption/transfer fee of $_____________.

b. ☐ Modification of the Existing First Lender's note to reflect interest at the fixed rate of ______% per annum, amortized over the loan's remaining term, with the principal balance due _____________, 20______.

c. ☐ ____.

4. GENERAL PROVISIONS:

4.1 All other provisions of the Existing First Lender's trust deed remain unaffected by this consent.

4.2 This consent is for only one further encumbrance by the New Junior Lender.

4.3 This consent inures to the benefit of the successors and assigns of the parties.

NOTE: The following agreements are used when an existing second trust deed will remain of record after further encumbering the property.

5. SUBORDINATION AGREEMENT to any modification agreed to in Section 3.3 above.

5.1 ________________________ is the Beneficiary under a second trust deed lien on the property recorded as Instrument No. _______________, in ______________________________ County Records, California.

5.2 The Existing Second Trust Deed Beneficiary consents to this modification and agrees to subordinate his trust deed to these modifications on demand.

5.3 The Existing Second Trust Deed Beneficiary consents to this further encumbrance and waives enforcement of any due-on clause in its trust deed.

5.4 The Existing Second Lender is____.

Date:___________, 20______. Signature of Existing Second Lender:___________________________________

EXISTING FIRST LENDER:

I agree to the terms stated above.

Lender: ____

By:____

Signature: ______________________________________

Title:____

NEW JUNIOR LENDER:

I agree to the terms stated above.

Lender: ____

By:____

Signature: ______________________________________

Title:____

Without the lender's **prior written waiver** of its due-on enforcement rights, triggered by future transfers, the lender can call the loan due on a later transfer of the buyer's interest in the property, such as a resale, further encumbrance, lease for over three years, court ordered transfer, foreclosure, death, etc. (with some exceptions for the principal residence).

A written waiver of the lender's **future enforcement** of the due-on clause bars the lender from calling the loan and protects the carryback seller for so long a time as the seller has an interest in the property. The **waiver agreement** assures the carryback seller he can protect his security interest in the title without due-on interference from the underlying lender. [See Form 410 accompanying this chapter]

To best protect the seller's trust deed, the seller should have the lender waive its right to call the loan:

- on the conveyance and further encumbrance of the property on the close of the carryback sale;

- for as long a period as the carryback trust deed remains of record; and

- on the carryback seller's reacquisition of title to the property should the seller have to complete a foreclosure on the property or accept a deed-in-lieu of foreclosure.

To be enforceable against the lender, the waiver must be in writing. [12 Code of Federal Regulations §591.5(b)(4)]

AITD and waiver

The all-inclusive trust deed (AITD) carryback is merely a variation on the standard carryback second trust deed. An AITD is a junior trust deed, typically a second.

However, in contrast to the standard trust deed, the AITD:

- secures a note for a principal amount which totals the unpaid balances on underlying liens and the balance of the seller's equity remaining unpaid after a down payment;

- obligates the carryback seller to remain responsible for making payments on the underlying liens; and

- does not involve the buyer in an **assumption** of the underlying (wrapped) loan. [See Chapter 22]

However, the creation of the AITD, recorded or not, still triggers the due-on clause, as does a grant deed, since it is a further encumbrance of the real estate.

Prior to closing an AITD sale, it is **the seller**, not the buyer, who negotiates any modification of the lender's trust deed note and arranges for the payment of any fees required by the lender to waive the due-on clause. The note modification by the seller increases the lender's portfolio yield through an increase in the note rates and the monthly payments, no different than if the buyer assumed the loan. Thus, the lender of record receives the same economic benefits of fees and market rates on the seller's modification of the loan as though the buyer had assumed and modified the loan.

In exchange for the fees and modification, the lender consents to the seller's AITD financing. As part of the negotiations, the lender agrees in writing to waive its rights under the due-on clause for as long as the carryback seller holds an interest in the property.

The seller carrying back an AITD retains the responsibility for paying the principal and interest installments and any impounds due the lender on the underlying loan. Thus, the **credit review** of the buyer by the lender is avoided since the seller remains the sole party responsible for payment.

After closing, instead of the buyer making payments on the underlying loan, the buyer makes installment payments on the AITD note directly to the carryback seller. On receiving installment payments on the AITD note from the buyer, the carryback seller pays the installment due on the underlying trust deed and keeps any remaining amount as his funds.

Broker's duty to disclose risks

All brokers in an installment sale have a duty to disclose the **existence** of a due-on clause in trust deeds of record. However, it is the duty of care owed to client which imposes on the different brokers in the carryback transaction the **duty to advise** their client on the legal and financial aspects of the trust deed's due-on clause.

For instance, the listing broker negotiating the carryback of a junior trust deed on behalf of a seller must inform the seller of the risks posed by the due-on clause in the existing trust deed. As for the buyer, it is the buyer's selling agent who is obligated to review the due-on risks and advise the buyer on the consequences of structuring the transaction to either:

- obtain the consent of the lender to the transfer and carryback financing, called a *waiver*; or

- take title *subject to* the existing trust deed. [See **first tuesday** Form 150 §4]

Also, the carryback seller must be informed and understand that a default by the buyer on installments on the all-inclusive trust deed (AITD) note will force the seller to advance the delinquent installment to the underlying lender, the task of the listing agent, not the buyer's agent. If the installment is not advanced, the seller risks having his AITD wiped out by the lender's foreclosure, a result no different then if the seller had carried back a regular second trust deed note.

It is the duty of all brokers involved in a carryback transaction to:

- **investigate** the provisions in a trust deed which is to remain of record, whether payments remain the seller's responsibility or become the buyer's; and

- **advise** their respective clients, be they the seller or the buyer, of the nature of any due-on clause.

The broker who fails to disclose the existence of the due-on provision to any party involved is liable for their losses caused by the lender's use of the clause. Also, if its existence is disclosed but the lender's rights are not taken into consideration when structuring the transaction, due-on related losses suffered by a broker's client due to the loss of their financial expectations in the transaction will impose liability.

For example, a buyer who is qualified to make payments on both the existing trust deed and a carryback note and who is not represented by a selling agent presents an offer to purchase property through the seller's listing broker.

The purchase offer provides for a small cash down payment with the buyer taking title **subject to** the existing trust deed. The seller is to carry back a note for the balance of the purchase price. The seller accepts the offer.

However, the buyer is not advised the recorded trust deed contains a due-on clause. Since an assumption of the loan by the buyer will not occur, a beneficiary statement is not ordered. A beneficiary statement would have disclosed the existence of the due-on clause to the buyer prior to closing, as would a copy of the recorded trust deed. [Calif. Civil Code §2943]

After escrow closes, the first trust deed lender discovers the sale and calls the loan due. The buyer, unable to pay the balance due on the first trust deed, ultimately loses the property through a foreclosure sale under the first trust deed.

The buyer seeks to recover his lost value from the seller's listing broker, claiming the broker had a duty to investigate and disclose the existence of the due-on clause.

The broker claims he owed no duty to the buyer to investigate or disclose title conditions contained in the recorded trust deed since the buyer was not his client.

Can the buyer collect the dollar amount of his lost equity from the seller's listing broker?

Yes! Any broker negotiating a transaction as an agent for either party must disclose title conditions affecting ownership or use of the property to both parties, not just his client.

A due-on clause in a trust deed is a title condition directly affecting ownership of the real estate. The clause affects the buyer's ability to maintain financing for the acquisition and continued ownership of the property. Thus, the seller's broker has a general duty to disclose the existence of a due-on clause to both parties involved in the transaction, not just his client. [**Pepitone** v. **Russo** (1976) 64 CA3d 685]

Waiver negotiations

A seller's listing broker can lessen the seller's risk of loss on a carryback sale by negotiating and obtaining a **written waiver** of the existing lender's future due-on rights prior to closing the transaction.

Also, the broker negotiating the carryback sale structured as an all-inclusive trust deed (AITD) or other wraparound financing agreement needs to anticipate the parameters of the lender's demand for increased interest and payments in exchange for a waiver of its due-on clause.

In turn, the interest rate and payment schedule negotiated for the AITD note should **equal or exceed** the interest rate and payment schedule the existing lender will demand as a modification of its note to consent to the sale.

If the AITD carryback sale is negotiated when market interest rates are the same or lower than the interest rate on the existing loan, the lender will be inclined to retain the original rate and demand only an assumption fee, often expressed in terms of points, for consenting to the seller's AITD sales transaction.

Conversely, in a market of rising interest rates when the existing lender's note rate is below market interest rates, the lender is certain to use the due-on clause to take advantage of the higher current rates and increase the note rate, and their yield, on the buyer's assumption or on the seller's modification in the case of an AITD transaction.

The AITD purchase agreement should specify the terms for modification of the existing loan which are acceptable to both the buyer and the seller, placing limitations on the interest, monthly payments, due date, and assumption fee to be negotiated by the seller with the lender. Alternatively, the purchase agreement can include a contingency for the seller's further approval of the modification demands by the lender to avoid impairing his AITD.

The carryback seller or his broker will need to negotiate the assumption or modification agreement with the lender, as well as any waiver of the lender’s exercise of its due-on rights for as long a period as the seller retains an interest in the property.

Chapter 29 — Required disclosures on seller carrybacks

This chapter discusses the financing disclosures a broker must make or consider making to a buyer and seller in a carryback transaction.

Mandated notices for risk assessment

A seller is willing to help finance the sale of his one-to-four unit residential property by carrying back a note and trust deed, sometimes called an *installment sale* or *credit sale*.

The seller's listing agent locates a qualified prospective buyer. The agent prepares an offer on a purchase agreement form and presents it to the buyer for his approval and signature since the buyer is not represented by an agent.

The terms offered for payment of the purchase price include a note and trust deed, to be signed by the buyer in favor of the seller, for the amount of the price remaining to be paid after the down payment and an assumption of the existing loan on the property.

A *Seller Carryback Disclosure Statement* is prepared by the listing agent and attached to the purchase agreement as an addendum. The addendum contains numerous statements on the financial, legal and other risk-of-loss aspects of the carryback note and trust deed. [See Form 300 accompanying this chapter]

The information entered in the **carryback disclosure statement** is based on the terms of the purchase offer, the title conditions, the activities to be undertaken in escrow and the information obtained from the buyer.

However, the agent's disclosures regarding aspects of the property, which might affect the transactional decisions of the buyer or the seller, are addressed in statements other than the carryback disclosure statement.

The carryback financing statement contains only the legislatively mandated **minimum disclosures** to be included. [Calif. Civil Code §2956]

Besides confirming delivery of the carryback disclosure statement to both the buyer and the seller, the listing agent, and any buyer's agent involved must be assured their respective clients understand and appreciate the risks and consequences which rise out of the **financial and legal aspects** of the carryback transaction. The duty of an agent to disclose to his client the agent's knowledge about the **tax aspects** of the carryback transaction depends on the type of property being sold and the agent's willingness to express an opinion on the subject. [See Chapter 54]

One-to-four unit carryback transactions

All brokered transactions for the purchase of **one-to-four unit residential property** involving seller carryback financing are controlled by statute. For one-to-four unit residential properties, a written carryback disclosure statement is **required** to be presented to both a buyer and seller for their review and signatures. [CC §§2956 et seq.]

FINANCIAL DISCLOSURE STATEMENT

For Entering into a Seller Carryback Note

NOTE: This statement is required to be prepared when the seller carries back a note executed by the buyer as part of the sales price for property containing four-or-less residential units. [Calif. Civil Code §2956]

This statement is to be prepared by the broker who obtains the signature of the person who first offers or counteroffers to buy, sell, exchange or option on terms which include a carryback note.

Both the buyer and the seller shall be handed a copy of this statement and sign it to acknowledge they have read and received a copy.

DATE:_____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

1. This is an addendum to the following agreement:

☐ Purchase Agreement ☐ Option to Purchase (with or without lease)

☐ Counteroffer ☐ Exchange Agreement

1.1 dated _____________, 20______, at ____, California,

1.2 entered into by____, as the Buyer,

1.3 and____, as the Seller.

2. This addendum was prepared by ____.

DISCLOSURES:

3. GENERAL INFORMATION CONCERNING THE TERMS OF PAYMENT:

3.1 The Note to be executed by Buyer is in the original amount of $_______________, payable in constant monthly _____________ installments of $_______________ to include ______% per annum interest, with a final/balloon payment due on _____________, 20______, in the approximate amount of $_______________.

3.2 The note will be secured by a trust deed on the property referred to as_____________________________ ____.

3.3 Should the Note contain a FINAL/BALLOON PAYMENT, the debt is not fully amortized. When the remaining balance of the Note is due and payable, there can now be no assurance that refinancing, modification or extension of the balloon payment will then be available to Buyer.

3.4 Unless stated and explained in an attached ARM addendum, the Note contains a fixed rate of interest with no variable or adjustable interest rates which would increase payments or result in a negative amortization of the debt. [See **ft** Form 155-1]

3.5 Unless otherwise agreed, the original amount of the Note will be adjusted by endorsement at the close of escrow to reflect differences in the then remaining balance of any underlying trust deed obligation(s) being assumed or obtained.

3.6 ☐ The Note and trust deed to be carried back by Seller is of the all-inclusive variety, and will contain provisions passing through to Buyer any prepayment penalties, late charges, due-on sale or further encumbrance acceleration and future advances due on the underlying wrapped loans.

4. SPECIAL PROVISIONS AND DISCLOSURES CONCERNING THE CARRYBACK NOTE AND TRUST DEED:

4.1 ☐ The all-inclusive Note and trust deed to be carried back by Seller contains provisions calling for Seller to place the Note on contract collection with any institutional lender or real estate broker, other than Seller, and the collection agent will be instructed to first disburse funds on payments due senior encumbrances. **NOTE: Inclusion of this provision may cause adverse income tax consequences for Seller.**

4.2 A joint protection policy of title insurance will be delivered to Buyer and Seller insuring their interests in title on the close of escrow.

4.3 The trust deeds and grant deeds to be executed will be recorded with the county recorder at the close of escrow.

4.4 Seller will be named, through escrow, as a loss payee under the hazard and fire insurance obtained by Buyer.

4.5 A tax reporting service ☐ will, or ☐ will not, be obtained by Buyer for Seller. If not obtained, Seller will assure himself that real estate taxes have been paid while he holds the Note.

4.6 ☐ Requests for Notice of Default and Notice of Delinquency under California Civil Code Sections 2924b and 2924e will be recorded and served on behalf of Seller on encumbrancers senior to the carryback.

4.7 Seller is aware that in the event of a default under the carryback Note and trust deed, his sole source of recovery is limited to the net proceeds from a foreclosure sale or his subsequent resale of the real estate; and he is not entitled to rental value for Buyer's occupancy or a deficiency money judgment under the Note. [Calif. Code of Civil Procedure §580b]

4.8 Buyer ☐ shall, or ☐ shall not, receive net proceeds or cash back upon the close of escrow. Amount to be received is $________________; source of funds ____; reason for receipt ____.

4.9 The Note shall include the following provision: "This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due."

5. ENCUMBRANCES SENIOR AND PRIOR TO SELLER'S CARRYBACK TRUST DEED AND NOTE:

5.1 Conditions of encumbrances, with priority over Seller's carryback Note and trust deed, which will remain or be placed of record at time of closing are as follows:

	First Trust Deed	Second Trust Deed
Original balance	$________________	$________________
Current balance	$________________	$________________
Interest rate	______% ☐ ARM	______% ☐ ARM
	Type: ____________	Type: ____________
Monthly payments	$________________	$________________
Due date	________, 20____	________, 20____
Balloon payment	$________________	$________________
Current defaults	$________________	$________________

5.2 If any of the senior encumbrances contain a due date, it may be difficult or impossible to refinance, modify or extend the balloon payment in the conventional mortgage marketplace.

6. BUYER CREDIT INFORMATION (SUPPLIED BY BUYER):

6.1 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

6.2 Seller may terminate the agreement within ______ days of receipt of the credit application by delivering to Buyer, Buyer's Broker or Escrow written Notice of Cancellation based on Seller's disapproval of Buyer's credit. [See **ft** Form 183]

7. BROKER DISCLOSURES:

7.1 Credit data is supplied by Buyer. Broker knows of no falsity or omission concerning Buyer's credit information.

7.2 This statement and its contents are statutorily required disclosures and do not limit Broker's duties to disclose other material facts about Seller to Buyer or Seller about the carryback financing arrangements and which are known to Broker or his agent.

7.3 Buyer and Seller are not to sign this statement until they have read and understood all of the information in it. All parts of the form must be completed before signing below.

7.4 ☐ See attached addendum for additional disclosures which are part of this disclosure. [See **ft** Form 250]

8. OTHER: ____

____

Date:______________, 20______	Date:______________, 20______
Buyer's Broker: ______________________	Seller's Broker: ______________________
By: ______________________	By: ______________________
I have read and received a copy of this statement.	**I have read and received a copy of this statement.**
Date:______________, 20______	Date:______________, 20______
Buyer: ______________________	Seller: ______________________
Buyer: ______________________	Seller: ______________________

Even the use of a *masked security device*, such as a land sales contract, lease-option or unexecuted purchase agreement with interim occupancy, requires written carryback disclosure statements. The written disclosure statements inform the buyer and the seller about the extent of the risks presented by failing to use grant deeds, notes and trust deeds to evidence an installment sale when the buyer takes possession. [See Figure 1; see **first tuesday** Form 300-1]

On the sale of a one-to-four unit residential property, any credit extended by the seller to accommodate the buyer's deferred payment of the purchase price requires a written carryback disclosure statement when the carryback arrangements include:

- interest or other finance charges;
- five or more installments running beyond one year;
- an installment land sales contract;
- a purchase lease-option or a lease-option sale;
- credit (note) to adjust equities in an exchange of properties; or
- an all-inclusive note and trust deed (AITD). [CC §2957]

Carryback disclosure statements are not mandated in carryback transactions creating **straight notes** which do not bear interest or include finance charges. However, carryback disclosures should be included as a matter of good brokerage practice since the risks and issues for the buyer and seller are similar and the duty owed the client is the same.

Consider a real estate agent who is acting as a property manager or leasing agent negotiating a lease for the landlord of a single family residence (SFR).

A prospective tenant makes an offer to lease the property. The offer contains an option to purchase the property on expiration of the lease. The terms for payment of the price under the proposed option include:

- a **carryback note**, to be executed on exercise of the purchase option (on expiration of the lease) for the balance of the seller's equity in the property after the down payment; and
- part or all of the lease payments are to apply as a credit toward the price and down payment on the property.

Here, the tenant's offer to lease coupled with the grant of a purchase option provides for a credit toward the price. Thus the credit **builds up an equity** in the property for the buyer. As a result, the agent is required to prepare the mandated carryback financing disclosures on a written form as an addendum to the lease-option. [See Figure 1]

Figure 1

FINANCIAL DISCLOSURE STATEMENT
For Entering into a Lease-Option Sale

NOTE: This disclosure statement is required to be acknowledged by both the Seller (Lessor/Optionor) and the Buyer (Lessee/Optionee) when the Seller extends credit requiring the Buyer to execute a debt obligation to defer payment for part of the sales price of property containing four-or-less residential units. [Calif. Civil Code §2956]
This disclosure is to be prepared and presented to all parties by the Broker of the party who offers or counteroffers to buy, sell, or exchange on a Lease-Option sales agreement.

DATE: _____________, 20_______, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
☐ Offer for Lease-Option [See **ft** Form 164]
☐ Lease-Option Contract for Deed [See **ft** Form 163]
1.1 dated _____________, 20______
1.2 entered into by ____, as the Lessee/Optionee, and
1.3 ____, as the Lessor/Optionor,
1.4 regarding property referred to as ____.

DISCLOSURES:

2. GENERAL INFORMATION CONCERNING TERMS OF PAYMENT:
2.1 The purchase price is $_______________. The price to be credited for $_______________ of option money paid and for ______%, or $_______________, of each payment of base monthly rent.
2.2 The Lease-Option provides for a final/balloon payment on exercise of the option. Thus, the debt is not fully amortized. On exercise of the option, the availability of refinancing, modification or extension of the final/balloon payment cannot be assured.
2.3 Lessee/Optionee will make Lease-Option payments to ____, who will be responsible for remitting these funds to Payees under senior encumbrances.
Notice: Lessee and Lessor may wish to use a collection agent for the purpose of accepting Lessee's payments and disbursing payment to underlying lenders and Lessor.
2.4 This Lease-Option is subject to the following provision: "This Lease-Option is subject to section 2966 of the Civil Code, which provides that the holder of this instrument shall give written notice to the Lessee/Optionee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due on exercise of the option." [See **ft** Form 419]
2.5 The Lease-Option wraps an existing trust deed, and any costs incurred by Lessor/Optionor for prepayment penalties, late charges, due-on-sale or further encumbrance acceleration and future advances will be passed on to Lessee/Optionee as increased rent. [See **ft** Form 163]

3. SPECIAL PROVISIONS AND DISCLOSURES:
3.1 ☐ Lessor will be designated as loss payee under Lessee's hazard and fire insurance.
3.2 Requests for Notice of Default and Notice of Delinquency under California Civil Code sections 2924b and 2924e ☐ will, or ☐ will not, be recorded for notice to Lessee/Optionee on encumbrances senior to the Lease-Option. [See **ft** Form 164 §7.4]
3.3 The Lease-Option is an unescrowed seller-financing transaction which is fully executed on delivery of the signed Lease-Option documents and possession.
3.4 The Lease-Option will not be recorded, which may cause Lessee/Optionee's title to the property to be impaired if liens are levied against the Lessor/Optionor.
3.5 Lessee/Optionee should consider obtaining title insurance on his real estate interest created by the option.
3.6 No tax reporting service will be obtained. Lessee/Optionee will assure himself that real estate taxes are paid by Lessor/Optionor during the option period.

— — — PAGE ONE OF TWO — FORM 300-2 — — —

— — — PAGE TWO OF TWO — FORM 300-2 — — —

3.7 Lessee/Optionee shall receive no proceeds or cash back on execution of the Lease-Option.
3.8 Lessor/Optionor is aware his sole source of recovery on Lessee/Optionee's default is limited to the net proceeds in the event of foreclosure under the Lease-Option. [Calif. Code of Civil Procedure §580b]

4. ENCUMBRANCES SENIOR TO THE LEASE-OPTION:
4.1 The conditions of encumbrances with priority over the Lease-Option include:

	First Loan	Second Loan
Original balance:	$______________	$______________
Current balance:	$______________	$______________
Interest rate:	______% ☐ ARM Type ___________	______% ☐ ARM Type ___________
Monthly payments:	$______________	$______________
Due date:	_________ 20____	_________ 20____
Balloon payment:	$______________	$______________
Current defaults:	$______________	$______________

4.2 If any of the senior encumbrances contain a due date for a final/balloon payment, it may be difficult or impossible to refinance, modify or extend the balloon payment in the mortgage marketplace.

5. LESSEE/OPTIONEE CREDIT INFORMATION:
5.1 ☐ Lessee/Optionee to hand Lessor/Optionor a completed credit application on acceptance [See **ft** Form 302]; and
5.2 Lessor/Optionor may terminate this agreement within ______ days of acceptance by delivering to Lessee/Optionee or Lessee/Optionee's Broker a written Notice of Cancellation based on disapproval of Lessee/Optionee's credit. [See **ft** Form 183]

6. BROKER DISCLOSURES:
6.1 Credit data is supplied by Lessee/Optionee. Broker knows of no falsity or omission concerning the Lessee/Optionee's credit information.
6.2 This statement and its contents, being statutorily required disclosures, do not limit Broker's duties to disclose other facts material to Lessee/Optionee or Lessor/Optionor.
6.3 This statement is an addendum to the agreement referenced at §1 and creates no rights to rescind the Lease-Option.
6.4 This statement was prepared by ____
____.

7. OTHER:
____
____
____
____
____
____
____

Buyer's Broker:	**Seller's Broker:**
By: ______________________________	By: ______________________________
I have received and read a copy of this statement.	**I have received and read a copy of this statement.**
Date: _____________, 20______	Date: _____________, 20______
Lessee/Optionee: ______________________	Lessor/Optionor: ______________________
Lessee/Optionee: ______________________	Lessor/Optionor: ______________________

FORM 300-2 04-08

Who prepares the disclosure

A carryback disclosure statement must be **prepared and submitted** to all parties in a carryback transaction on one-to-four unit residential property by:

- the real estate broker, or his agent, who **negotiated** the carryback sales transaction and prepared the buyer's purchase offer; or
- the buyer or seller who is a real estate licensee or attorney, when neither the buyer nor the seller is represented by a broker. [CC §2957(a)(2)]

When both the buyer and seller are represented by **different brokers**, the carryback disclosure statement is prepared by the broker or agent who prepared the buyer's offer.

Many participants in a carryback sale transaction are not required to make carryback disclosures, including:

- escrow officers [CC §2957(a)(3)];
- attorneys representing a party and not also acting as a real estate licensee [CC §2957(a)(1)]; and
- individual buyers and sellers when acting as principals without the assistance of a broker, unless they are real estate licensees or attorneys. [CC §2957(a)(1)]

Offer includes disclosures

The best policy for a **buyer's agent** is to eliminate the need for further approval of the statutory carryback disclosures by **preparing and attaching** a carryback disclosure statement as an addendum to the purchase agreement. If the disclosure statement is not attached, it would be prudent for the **listing agent** to include it as an addendum to a counteroffer to eliminate the disclosure contingency. [CC §2956]

If neither the buyer's or seller's agent prepares and includes the disclosures as an addendum to the offers or counteroffers, then, as a minimum requirement, the **buyer's agent** is responsible for preparing the disclosures and obtaining both the buyer's and seller's signature **prior to closing** the carryback sales escrow. [CC §2959]

However, after a purchase agreement has been entered into, and until the carryback disclosure statement is approved by the buyer and seller in a one-to-four unit transaction, a **statutory contingency** exists in favor of the buyer allowing the buyer to cancel the transaction. The right to cancel does not arise if the carryback disclosure statement is attached as an addendum to the offer or counteroffer. [See Form 300]

If the buyer receives the carryback disclosures after entering into the purchase agreement and discovers a reasonable basis for disapproving it, he may cancel the transaction and terminate his obligation to purchase the property. [CC §2959]

However, the buyer may not arbitrarily cancel the sale when he is presented with the carryback disclosure statement for his acknowledgment and approval during escrow. To cancel, the buyer must act in good faith by showing the carryback disclosures are inconsistent with his **reasonable expectations** when he entered into the purchase agreement. [CC §2961]

After closing, the only legal remedy available to the buyer or seller for inadequate or nonexistent financial disclosures is to pursue the brokers for any money losses actually incurred as a result of the nondisclosure. If a broker or his agent fails to make the mandated carryback disclosures, he is liable to the buyer for the buyer's losses resulting from the non-disclosure. [CC §2965]

Contingency exercised to cancel

Consider a buyer and seller of a single family residence who enter into a purchase agreement. The terms call for carryback financing in the principal amount of $250,000 with an interest rate of 6%, payable in monthly installments with a 30-year amortization and a five-year due date for a final/balloon payment.

The purchase agreement does not state the dollar amount of the balloon payment due on the carryback note at the end of five years. The risks imposed and the consequences of failure to meet the five-year due date are not brought to the buyer's attention by his agent prior to entering into the purchase agreement.

Further, a carryback financial disclosure statement is not presented to the buyer or seller for their signatures as part of the purchase agreement and counteroffer negotiations. Thus, closing is automatically contingent on the buyer's and seller's **further approval** of the financial and legal aspects of the carryback note and trust deed as presented in the carryback disclosure statement.

Prior to closing, the buyer receives the carryback disclosure statement. He discovers his final balloon payment at the end of five years will be $232,600. The buyer is now concerned about the financial risks of ownership since he has no assurance he will be able to refinance, modify or extend the note, much less have the ability to accumulate funds in the interim for payoff of the final/balloon payment.

Unable to negotiate an extension agreement with the seller, the buyer cancels the purchase agreement and escrow, claiming he did not previously realize the extent of the financial risk created by the due date in the carryback financing. He is now aware the due date could force him to sell the property or lose it to foreclosure should he be unable to arrange refinancing or an extension of the carryback note. [See **first tuesday** Form 418-3 §2.2]

Can the buyer cancel the transaction as permitted by statutes due to a delayed financial disclosure by the agents?

Yes! The buyer did not sign the carryback disclosure statement at the time he agreed to buy the property. This failure triggers the **statutory further-approval contingency** allowing the buyer to cancel the transaction. The risks of loss imposed by the amount of the final/balloon payoff were significantly greater than the buyer realized when entering into the purchase agreement. Thus, the buyer has justification for exercising his right to cancel since the sale did not meet his reasonable expectations.

Approximations when uncertain

A purchase agreement entered into by a buyer and seller calls for:

- a 10% down payment;
- a new loan of no less than 60% of the purchase price; and
- the seller to carry back a note for the balance of the purchase price at 6% interest, amortized monthly over 30 years with a ten-year due date.

Thus, the precise amount of the carryback note provided for in the purchase agreement could be any amount up to 30% of the purchase price, depending on the loan amount available from a lender.

When the agent prepares the carryback disclosure statement, the amount of the carryback note and new loan can be disclosed as dollar figures he **reasonably believes** will exist at the time of closing. The carryback figures may be an approximation of the unknown amounts.

The **approximation** must be clearly identified as "approximate," or "approx.," in the carryback disclosure statement, and be based on the best information available to the agent. The approximation may not be used as an excuse to evade compliance with disclosure laws. [CC §§2960; 2961]

Further, as amounts approximated in the original carryback disclosure statement become certain and are available to the buyer's agent, he must at that time disclose the new figures in a written amendment signed by both the buyer and seller. [CC §2962; see **first tuesday** Form 250]

However, if figures and facts presented in the carryback disclosure statement change due to actions taken by the buyer or seller after making the disclosures, the agent is not obligated to amend the carryback disclosure statement, but should do so to conform all the paperwork to the transaction prior to closing. [CC §2960]

Buyer's ability to pay

A buyer's ability to meet the terms and conditions of a carryback note is of financial importance to a seller who is carrying back a note on a sale. Thus, a listing agent must alert his seller to facts about the buyer's financial condition which are known to the listing agent and his seller is not yet aware of.

For example, a listing agent locates a buyer willing to purchase his seller's property on terms which include a carryback note and assumption of the existing trust deed lien on the property. The agent advises the seller that the buyer is financially qualified to handle the cash down payment and monthly payments on the carryback financing.

Relying on his agent's representations regarding the buyer's financial qualifications, the seller agrees to carry paper to finance the sale.

Before escrow closes, the buyer tells the agent he does not have the cash down payment and will need to obtain a loan. The listing agent does not disclose the buyer's lack of capital to the seller. Further, the listing agent makes a loan to the buyer to help fund the down payment of the property.

Escrow closes and the buyer takes title to the property. Shortly after taking title, the buyer defaults on the carryback note and trust deed held by the seller. The seller suffers a total loss on his carryback note due to a foreclosure sale on the first trust deed.

The seller then discovers his listing agent loaned the buyer the money he needed for the down payment. The seller also discovers the agent knew the buyer was financially unstable prior to closing the transaction.

In this scenario, the listing agent had a primary agency duty to advise the seller of the buyer's reduced financial capability to repay the carryback note, a significant adverse fact which came to the seller's listing agent's attention prior to closing. Thus, the agent and the agent's broker are liable to the seller for the seller's money losses on the carryback note. The listing agent failed to disclose his knowledge of the negative aspects of the buyer's revised or altered financial status. [**Ziswasser** v. **Cole & Cowan, Inc.** (1985) 164 CA3d 417]

A seller willing to enter into a credit sale **needs to know** the prospective buyer will be able to make the payments and pay the operating costs incurred as owner of the property. As carryback financing becomes more prevalent during cyclical periods of declining real estate prices and tight mortgage money conditions, more unqualified buyers appear with whom agents must contend.

To filter out unqualified buyers as part of the carryback disclosure process, the listing agent has an **affirmative duty** to obtain a written financial statement from the buyer and hand it to the seller of one-to-four unit residential property. [See Form 300 §4]

The seller's risks change as a creditor

One purpose of a carryback disclosure statement is to inform a seller that owners and lenders are bound by different rules; that they face different risks based on their respective possessory and security interests in real estate.

For example, while a buyer is concerned with paying no more than the *fair market value* (FMV) for a property, the carryback seller is concerned with his loan-to-value (LTV) ratio, whatever the price may be, since he will become a "financier" on the close of escrow.

Typically, a seller wants to receive the highest sales price negotiable for his real estate. However, the seller as a carryback lender wants assurance the buyer's down payment is a large enough amount as a percentage of the purchase price to establish **adequate equity value** in the real estate, over and above the amount of the carryback trust deed note. An adequate loan-to-value (LTV) ratio allows for full recovery of the carryback note from the value of the property should a default require the seller to foreclose on the property. Any lesser amount of equity exposes the carryback seller to additional risk of loss.

Chapter 30 Carryback foreclosure and resale costs

This chapter discusses the risks undertaken by a seller on an installment sale should the buyer default, and the safeguards to consider for covering those risks.

Protection is led by disclosures

An absentee owner is unable to effectively manage a small income-producing property he owns. Confronted with below market rents, unreliable tenants and deferred maintenance, he decides to sell the property. The condition of the property and its income will continue to deteriorate until it is sold to a local buyer who has cash reserves and can provide hands-on management.

The owner contacts an agent for the purpose of marketing the property and locating a suitable buyer. The property has an existing fixed-rate, long-term loan which can be assumed by a qualified buyer. The listing agent believes the seller's asking price for the property is properly set to attract an investor.

To pursue his asking price and pass on the cost of disrepair and the delinquent rent situation to the buyer, the seller lists the property with the agent's broker to market the property for sale and locate a buyer. The listing terms for payment of the price include a low down payment and a **carryback note** and trust deed.

The seller and his listing agent agree an acceptable offer must include a *further-approval contingency* calling for the owner to confirm the buyer is financially and personally qualified to purchase the property, and is ready with cash to cure the deferred maintenance and upgrade the tenancies on the property. [See **first tuesday** Form 159 §§8.4 and 8.5]

However, the listing agent quickly concludes the owner is not familiar with real estate financing techniques and does not fully understand the **risk-of-loss** involved in carrying back a second trust deed note. The risks, if known and understood, might cause a (prudent) seller to take additional steps beyond a carryback trust deed to cover the risks and protect his continuing investment represented by the carryback note. The listing agent knows he is **duty bound to inform** the owner of the risks of carrying back a second trust deed note, so appropriate decisions can be made regarding the terms for payment of the sale price and management of the carryback note and trust deed.

Agency duties and carryback risks

Sellers often do not know what risks of loss exist when carrying back paper, much less understand or even ask about them. Brokers and their agents who represent carryback sellers under a listing must be knowledgeable enough to provide essential risk-management information for the care and protection of their clients.

Listing agents who do not know or understand the risks of carrying back paper on a sale often brush them aside as minimal. However, sellers need to be advised that they must consider risk reduction remedies other than just "taking back the property" if their buyer defaults.

When a seller does not inquire about the risks, his listing agent has an **affirmative duty** to voluntarily advise the seller of the **risks known** to the broker and the agent, and recommend any due diligence investigation or analysis the agent believes they or the seller should undertake in a carryback sale.

Risks posed to a creditor involved in holding carryback paper differ dramatically from the more commonly understood risks of owning real estate. When the seller carries back paper on the sale of property, his ownership interest is exchanged for a creditor's (lender's) secured position in the property, called a *security interest*.

Covering the risks of junior financing

The risks of carrying paper are similar to the risks taken by an equity lender holding a comparable junior lien position on title to a property. The risks of a junior lender, and thus a carryback seller, are covered or compensated by employing several techniques and variables, including:

1. The amount of the buyer's **down payment**, as it sets the amount of both the equity the buyer feels compelled to protect and the cash sales proceeds the seller nets to cover the risk of future advances he may have to make should the buyer default;

2. **Further collateral**, as additional security to the equity in the property, be it personal property or other real estate, a situation sometimes called *cross collateralization*, an event which converts a carryback note to *recourse paper* and avoids anti-deficiency laws;

3. A **personal guarantee** from someone other than the buyer, which may be secured by real estate owned by the *guarantor*, and is a "put option" requiring the guarantor to pay off (buy by assignment) the carryback note on the buyer's default [See Form 439 in Chapter 13];

4. A **premium interest rate** on the note, a note rate greater than the current market rate which further covers the risks created by a down payment inadequate in amount to provide the seller with sufficient cash sales proceeds to pay all the costs of foreclosure and resale of the property should the buyer default (the interest rate for this minimal down payment situation would be comparable to sub-prime mortgage rates and junk bonds which are generally 3% to 6% above prime rates);

5. **Monthly payments** based on a short amortization schedule to quickly reduce the principal balance remaining on the note and increase the seller's cash reserves before a default (which usually does not occur for three to five years, except during cycles of severe declines in property values);

6. **Private mortgage insurance** (PMI), available from insurance companies if the buyer qualifies, to cover any loss of principal and interest due to a default by the buyer [See Chapter 40];

7. **Assignment of rents** as additional security (in the form of cash) if the property is income property. Rents can be readily collected by the use of pre-printed notices sent to both the buyer and the tenants which informs them to pay the carryback seller or be personally liable to the carryback seller for nonpayment [See Chapter 17];

8. A **credit application** and a **net worth statement** (balance sheet) from the buyer, authorization to order out a credit report to confirm the buyer's propensity to timely pay his debts, debt to income ratios with several months cash reserves for payments, and by a review of the buyer's assets for sufficient equity to bolster the buyer's ability to pay the carryback note (and possibly provide additional security for the carryback note) [See Form 302 in Chapter 32 and **first tuesday** Form 207-1]; and

9. **Inspect and investigate** the care and management of real estate owned by the buyer to determine if he maintains and operates property without deferring maintenance.

The foreseeability of a default

A lender becomes acutely aware of his rights and obligations when a **buyer defaults**, a foreseeable occurrence against which the trust deed lien is the first line of defense.

When the buyer defaults on a trust deed, the carryback seller may proceed with a foreclosure and recover what is owed him from the value of his security interest in the property. Defaults on a trust deed include the buyer's failure to:

- pay installments on the carryback note;
- pay property taxes, assessments and hazard insurance premiums;
- pay senior lenders; or
- maintain the property.

During the foreclosure period, the carryback seller may need to draw on his cash reserves to keep the senior trust deed note current and avoid the initiation of foreclosure proceedings by a senior lender. Commencement of foreclosure by the senior lender will add to the carryback seller's costs of recovering the property.

If the downpayment amount is a small percentage of the price, which results in a high loan-to-value (LTV) ratio for the carryback seller, the seller who begins foreclosure and makes a full credit bid stands a good chance of taking the property back at the trustee's sale.

Most importantly, the seller's source of recovery on a carryback note which is secured solely by the property sold is limited to the value of his *security interest* held under the second trust deed lien. The dollar value of a junior trust deed holder's secured position on the property's title is the property's fair market value, minus:

- the balance remaining due on the senior loan;
- the dollar amount of foreclosure;
- resale costs; and
- carrying costs (taxes, insurance, operating expenses) until the property is resold.

Any rents collected from tenants by the seller due to the seller's enforcement of his assignment of rents lien (in the trust deed) will be applied to offset the costs of "carrying" the property during foreclosure and the amounts due the seller to set the amount of an underbid at a trustee's sale. Also, interest on the carryback will be unpaid and uncollected unless paid on a bid by a cash buyer at the trustee's sale, or recovered in the resale price should the seller recover the property at the trustee's sale and resell it.

For the seller to limit his risks of lost equity and interest on non-income producing property, the cash proceeds from the buyer's down payment on the initial sale of the property must equal or exceed the total of eight to twelve months of senior trust deed payments, other carrying costs incurred during this period,

and foreclosure and resale costs. If the buyer's down payment is large enough, the value of the seller's security interest in the property should be sufficient to recoup the principal balance and interest on the carryback note, the property's carrying costs and the costs to foreclose and resell the property.

The listing agent representing the broker must prepare and review a *Foreclosure Cost Sheet* with the carryback seller to impress upon the seller that he needs an adequate down payment (or additional security or a guarantee). The information in the disclosure will aid everyone in an analysis of the risks a second trust deed holder is exposed to and the steps to be taken to cover those risks. [See Form 303 accompanying this chapter]

The **Foreclosure Cost Sheet** is useful as a visual aid to make these disclosures about the financial risks of a carryback sale. The worksheet also documents the agents disclosure of the potential expenditures, and the cash reserves required to cover the risk of the buyer's default.

Foreclosure cost calculations are made by the agent and reviewed with the seller who is considering an installment sale on each of two occasions:

- once when accepting the listing; and

- a second time when presenting an offer.

Lastly, a major hidden cost of foreclosure is the **time and energy** spent by the carryback seller to keep track of any foreclosure and resale process he may have to undertake. The recovery of this opportunity cost is built into the increased sales price for the property, the increased interest yield and the increased monthly payment amount on the carryback note.

The foreclosure risk of having to sell the property again is often shared by the brokers and agents through various deferred fee arrangements to reduce any moral hazards present in an optimistic agent's encouragement of the seller to accept the terms of an offer calling for a carryback sale note.

A deed-in-lieu

When the amount of an underlying senior loan is more than 75% of the property's current market value and a buyer defaults on the seller's carryback note, the seller should first negotiate with the buyer for a *deed-in-lieu of foreclosure* and possession to the property before initiating foreclosure. Negotiations for a **deed-in-lien of foreclosure** should be considered at the time of the default, but must be considered before commencing foreclosure.

A deed-in-lieu is a grant deed containing special language to assure title insurers the debt has been canceled, and no lease-option or other lender/debtor relationships has been created to cause the deed-in-lieu to be recharacterized as a *mortgage-in-fact*. [See Chapter 50]

A deed-in-lieu, as a preforeclosure workout, eliminates many of the financial risks of foreclosing. The deed-in-lieu saves the carryback seller the high cost of foreclosure, while possibly providing the buyer with some "walking money" or "key money," consideration for immediately conveying title and transferring possession to the seller under the deed-in-lieu.

Also, the deed-in-lieu **must be insured** by a title company before the seller accepts it. Without title insurance on the deed-in-lieu to confirm the condition of the title, liens may have attached to the property or a change in vesting may have occurred which renders the deed unacceptable.

FORECLOSURE COST SHEET

Costs and Net Proceeds on Foreclosure and Resale

NOTE: This cost sheet is prepared and presented to carryback sellers and lenders secured by a junior trust deed. These disclosures help junior trust deed holders anticipate the funding necessary to foreclose and the net proceeds of a foreclosure and resale.

The figures estimated in this cost sheet will vary with time and thus are not a guarantee.

This form does not consider the effects of a bankruptcy, eviction, lost interest, or assignment of rents provision.

1. This estimate of costs incurred to foreclose and resell property under a trust deed is prepared for the following:

☐ Purchase Agreement ☐ Loan Agreement ☐ Exchange Agreement

☐ Trust Deed and Note ☐ Option

1.1 dated ______________, 20______, at ____, California,

1.2 entered into by ____,

1.3 regarding property referred to as ____.

2. Estimated resale value of the real estate . . . . $_______________

3. Balances on senior trust deeds at time of resale

3.1 Underlying first . . . . $_______________

3.2 Underlying second . . . . $_______________

4. Cash advances from the time of default through closing of a resale

4.1 Taxes . . . . $_______________

4.2 Insurance . . . . $_______________

4.3 Improvement bond assessments . . . . $_______________

4.4 Common interest development assessments (condos) . . . . $_______________

4.5 Payments on underlying trust deeds (number of months ______). . . . . $_______________

5. Foreclosure costs and fees to recover a property

5.1 Trustee’s guarantee policy . . . . $_______________

5.2 Recording notices . . . . $_______________

5.3 Publishing notices . . . . $_______________

5.4 Postage . . . . $_______________

5.5 Trustee’s fees . . . . $_______________

5.6 Miscellaneous charges. . . . . $_______________

6. Resale costs after foreclosure and recovery of the property

6.1 Repairs and fixer-up costs . . . . $_______________

6.2 Title insurance premiums . . . . $_______________

6.3 Escrow fees and charges. . . . . $_______________

6.4 Broker fees and charges . . . . $_______________

7. Estimated loans, advances, costs and charges to foreclose and resell (3, 4, 5 and 6): . . . . (-)$_______________

8. **Estimated net proceeds available to pay off carryback trust deed** . . . . $_______________

I have diligently prepared this estimate.	I have read and received a copy of this estimate.
Date: ___________, 20___________	Date: ___________, 20___________
Seller's Broker: ______________________	Seller's Name: ______________________
By: ______________________	Seller's Signature: ______________________
	Seller's Signature: ______________________

Foreclosure

If a deed-in-lieu remedy or other pre-foreclosure workout (short payoff sale or modification of the note) is not available to resolve a default, a trustee's foreclosure sale is the next most expedient procedure for recovery on a defaulted note.

However, some or all of the financial benefits of a carryback note may be reduced by the carrying costs and trustee's charges incurred during a trustee's foreclosure if the down payment is inadequate (less than 15% to 20% of the price), the value of the property does not rise or the seller procrastinates in commencing foreclosure on a default.

For example, suppose a buyer pays $100,000 down and assumes $800,000 in existing loans on a $1,000,000 sales price. The seller carries back a $100,000 note secured by a trust deed lien on the property sold for the balance remaining to be paid on the purchase price.

The brokerage fees and other costs, credits and adjustments associated with the sale amount to $50,000. Thus, the seller's net proceeds on the sale are $50,000 cash and the $100,000 in paper. [See **first tuesday** Form 310]

However, foreclosure and resale costs can run from 15% to 20% of the property's resale value, in this case, $150,000 or more. More than half of this amount would be met from the seller's cash reserves to pay foreclosure and other carrying costs until the property is resold. Foreclosure on income producing property can be less demanding on a seller's cash reserves since the carrying costs may be offset by rent received under the trust deed's assignment of rents provision. [See Chapter 50]

The carryback seller is also subject to the risk the buyer may file a **bankruptcy petition** to preserve any equity he may have in the property. The carryback seller's foreclosure sale is automatically halted by filing the petition, called a *stay*, and remains in effect until the bankruptcy court releases the stay.

Any delay in the foreclosure process results in further expenditures to pay the property's carrying costs — caused by an insolvent and distraught buyer. Further, a buyer who realizes he will lose the property often fails to continue to properly maintain the property, called *impairment of the security* or *waste*.

If only deferred maintenance occurs, the carryback lender will incur the expense for **fixing up** the property to resell it (or to keep it and rent it).

These conditions are common risks any mortgage lender is exposed to. As with all mortgage risks, the risks are manageable and capable of being covered by a mix of a sufficient down payment, a premium interest rate, assignment of rents on income property, a short amortization period, additional security and guarantees. A real estate market of rising values is always a cure for a failure to adequately cover the risks of loss.

Eviction by the involuntary landlord

A buyer wiped out by a foreclosure sale must vacate and deliver possession of the property to the carryback seller who acquires it at a foreclosure sale. If the buyer does not vacate, the seller must serve the buyer with a written *Three-Day Notice to Quit Due to Foreclosure*. [Calif. Code of Civil Procedure §1161a(b); see **first tuesday** Form 578]

However, a wiped-out buyer might refuse to vacate the property on expiration of the three-day notice. If this occurs, the carryback seller will need to proceed with an *unlawful detainer* (UD) action, as would any landlord dealing with any tenant who unlawfully detains the property.

At the **unlawful detainer** hearing, the carryback seller must show the property was acquired at a trustee's sale and all statutory notice requirements for the sale and the UD action have been satisfied to evict the buyer.

After foreclosure and recovery of possession, the carryback seller who reacquires the property is back to square one — he owns the property again, minus his out-of-pocket expenses to foreclose.

A tenant or subtenant in possession of a residential unit at the time of a foreclosure sale must be given 60 days' written notice to quit before the tenant or subtenant may be removed from the property by an unlawful detainer action:

- tenant;
- subtenant; or
- occupant.

Other security devices

Land sales contracts, reverse trust deeds, unexecuted purchase agreements with occupancy (lease-purchase sale) and lease-option sales, are **installment sales** which typically include the additional risk and cost of a **judicial foreclosure** should the buyer default and challenge an eviction action.

The completion of a foreclosure of the lien created by any security device is a requisite to recovering possession, since the buyer's *right of redemption* (to pay off the debt) must be eliminated to clear title of the buyer's ownership interests. These alternative security devices do not usually contain a *power-of-sale* clause to authorize the more efficient, less expensive trustee's foreclosure sale. [See Chapter 35]

The exposure to the repossession risk of a judicial foreclosure outweighs any purported benefit these alternative security devices might offer on a small-downpayment installment sale to a buyer.

Chapter 31 Buyer's creditworthiness: seller's further approval

This chapter comments on a carryback seller's need to investigate and analyze a buyer's creditworthiness and capacity to pay.

The informed seller carries paper

An offer submitted by a buyer to purchase real estate calls for the seller to carry back an **unsecured note** for a portion of the sales price. The balance of the price will be paid with a cash down payment and the assumption of an existing loan on the property. The seller is given ten days after acceptance of the offer to further approve the buyer's creditworthiness and net worth, or cancel the transaction. [See Figure 1]

The buyer wants to acquire the property clear of any carryback encumbrance so the equity in the property can be used to finance the acquisition of other property.

On presentation of the offer, the seller's listing agent advises the seller that the buyer's financial statements indicate the buyer's net worth as itemized on the balance sheet includes the ownership of numerous properties known to the broker.

Relying on his agent's representations of the buyer's net worth, the seller accepts the offer. Prompted by the listing agent, the seller approves the buyer's credit, thus waiving the further-approval contingency. [See **first tuesday** Form 182]

Cash back disclosure

Prior to the close of escrow, the buyer informs the listing agent he needs to pay the brokerage fee with a promissory note to replace the cash fee the seller has agreed to pay his broker. The buyer has insufficient funds for the agreed-to down payment.

To close the transaction without bringing the buyer's lack of funds to the seller's attention, the agent enters into a "cash back" arrangement with the buyer. This arrangement will help the buyer fund the down payment, which in turn will fund the seller's payment of the brokerage fee.

Under the arrangement, the buyer and the agent will exchange a check from the agent payable to the buyer for a note from the buyer payable to the agent, both for the amount of the brokerage fee. On closing, the agent will deposit the fee paid by the seller into the agent's account and hand his check on that account to the buyer. In turn, the buyer will hand his promissory note to the agent. The brokerage fee paid by the seller on closing will cover the check issued by the agent to the buyer.

Figure 1 *Excerpt from Form 150 §8.4 and 8.5*

Buyer credit information

8.4 Buyer to hand Seller a completed credit application on acceptance. [**ft** Form 302]

8.5 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

Further, the buyer finances the remaining portion of the down payment through a new loan arranged by the listing agent with a private lender. Thus, the buyer has restructured the entire down payment to avoid the investment of any of his **personal funds**.

The seller is not informed of the purchase-assist loan or the cash-back arrangement. Also, the seller's agent is aware the representations of the properties and the financing listed on the buyer's financial statement approved by the seller significantly overstate the buyer's net worth.

The transaction closes. Eventually, the buyer defaults on the unsecured carryback note, which is recourse paper collectible by a money judgment.

The seller is only able to recover a portion of the outstanding balance on the carryback note from the buyer.

The seller seeks to recover his loss on the carryback note from the agent's broker, claiming the broker and his listing agent wrongfully induced him to accept the unsecured carryback note.

Is the broker or his listing agent liable for the seller's losses due to the buyer's default?

Yes! The broker and his listing agent are both liable for the seller's losses. The agent intentionally misrepresented the buyer's ability to perform on the carryback note to induce the seller to enter into the installment sale with the buyer. [**Alhino** v. **Starr** (1980) 112 CA3d 158]

Broker's agency duty

The duty owed the seller by the broker's listing agent to disclose the **buyer's credit status** includes:

- correctly representing to a carryback seller a buyer's ability to meet the obligations imposed on him by entering into a carryback note;
- disclosing information about the prospective buyer's/borrower's identity, occupation, employment, income, and credit data as known to the broker and his listing agents;
- disclosing the buyer's existing and future loan obligations, including payment history and any pending bankruptcy known to the broker and his listing agent; and
- affirmatively advising on any credit investigation which should be conducted.

Also, written disclosures itemizing the buyer's credit information are mandated on all sales involving one-to-four unit residential properties when the seller carries back a portion of the sales price. [Calif. Civil Code §§2956 et seq.; see Chapter 29]

All disclosures must be made in *good faith* by the buyers, brokers and agents to meet the objective of the credit investigation. [CC §2961; see Form 302 accompanying this chapter; see **first tuesday** Forms 207 and 207-1]

The listing agent provides his seller with the buyer's credit information so the seller can make an informed decision to either proceed with the transaction or cancel it under a further-approval contingency in the purchase agreement. [See **first tuesday** Form 158 §8.5]

Any real estate agent who misrepresents a buyer's credit information or makes false statements to the carryback seller about the buyer's ability to repay the carryback note, is not only liable for money damages, but faces suspension or revocation of his license for committing fraud. [Calif. Business and Professions Code §10176]

The need for credit checks

A carryback seller must determine the creditworthiness of the buyer for the same reason a landlord must obtain reliable credit information on prospective tenants — will they, and are they able to, pay as agreed.

Accurate credit information on the buyer helps the seller analyze the **risk of default** when extending credit to the buyer. Also, the seller must assure himself the buyer will **maintain the property unimpaired** under the carryback trust deed. In other words, if the buyer is unqualified, the seller may justifiably cancel the transaction.

The buyer must have the financial ability and credit history to pay both the first trust deed loan and the second trust deed note carried back by the seller before the seller approves and proceeds to close the sale. Any default by the buyer on the first trust deed jeopardizes the seller's security interest in the property under his second trust deed lien.

The listing agent checks the buyer's creditworthiness and ability to perform by:

- analyzing an application for credit, along with credit reports, telecredit checks and criminal background reports he orders out [See **first tuesday** Form 203 and 302];
- reviewing financial statements, both an operating statement (profit and loss report) and a balance sheet (net worth statement) and confirming the bank balances [See **first tuesday** Forms 207 and 207-1];
- contacting the buyer's creditors (sellers, landlords, lenders) for their experiences with the buyer's payment history; and
- inspecting properties owned by the buyer to determine the level of care and maintenance the properties receive which are owned and managed by the buyer.

All carryback sellers face the risk a buyer will default, no matter how wealthy, conscientious and qualified the buyer might appear to be. On any default in payments on a trust deed note, the seller's **sole source of recovery** is a resort to the secured property, unless the note is subordinated to a construction loan or additionally secured by property other than the property sold.

Even an existing trust deed lender has a right to obtain credit information from the buyer on a change of ownership. The lender, like a carryback seller, needs to make an informed decision as to whether the risk of default in the payments or care and management of the property will increase under the new ownership, called *impairment*. [**Santa Clara Savings and Loan Association** v. **Pereira** (1985) 164 CA3d 1089]

The right to obtain credit information also applies to private parties such as carryback sellers.

For example, private lenders rely on their agents to obtain necessary information on the borrower's ability to comply with the terms of both the **note** (payments) and the **trust deed** (care and maintenance).

A private lender does not typically have the resources of institutional lenders to personally investigate and assess a buyer's creditworthiness and management capabilities prior to making a loan. Thus, a broker or an agent who assists private lenders and carryback sellers is obligated to help them determine the buyer's ability to operate the property and his propensity to make payments on a promissory note. [**Dawn Investment Co., Inc.** v. **Superior Court of Los Angeles** (1982) 30 C3d 695]

The creditworthiness contingency

A listing agent has the duty to obtain accurate credit information and disclose any facts known or readily available to him which might affect the seller's decision to carry paper in the transaction.

A **carryback disclosure statement** should be attached to any purchase agreement containing a carryback note. The carryback disclosure statement is mandated on the sale of four-or- less residential units. However, a prudent listing agent will also require a disclosure statement in carryback transactions on **all types** of property. [CC §§2956 et seq.; see Form 300 in Chapter 29; see Chapter 3]

Both the carryback disclosure statement and the purchase agreement includes a credit approval contingency. The **further-approval contingency** calls for the buyer to hand the seller a completed *credit application*. [See Form 302]

The agent preparing a carryback offer should consider having the buyer fill out the **credit application** on commencement of negotiations and attach it to the buyer's purchase agreement offer as an addendum. Early disclosure helps the seller to determine the buyer's sincerity and good-faith willingness to cooperate in the credit analysis process.

A review of the buyer's financial statements and the agent's verification of earnings and funds can be cleared during the contingency period. [See **first tuesday** Forms 208 through 213]

The credit contingency allows the carryback seller to terminate the purchase agreement by a written *Notice of Cancellation* should he disapprove of the buyer's creditworthiness. [See **first tuesday** Form 150 §10.5]

However, the credit contingency does not give the carryback seller the unrestricted right to withdraw from a binding and otherwise enforceable purchase agreement.

For example, a carryback seller enters into a purchase agreement containing a credit approval provision which gives him the right to cancel the transaction based on the buyer's lack of creditworthiness. [See Figure 1 §8.5]

During the contingency period and before the seller approves the buyer's credit, the seller changes his mind about selling the real estate. He decides to cancel the transaction by using the credit contingency as a "weasel clause," or "back door provision," in an attempt to escape enforcement of the purchase agreement. The seller has no grounds for disapproving the buyer's credit since he has received no derogatory information about the buyer's creditworthiness or ability to perform on the purchase agreement or the carryback note.

The seller must have good reason to disapprove the buyer's credit and cancel the transaction. A reason to cancel the transaction must relate to the creditworthiness sought to be determined under the contingency provision. Without good reason, the seller who cancels has breached the purchase agreement in bad faith by wrongfully using the credit contingency. [**Lyon** v. **Giannoni** (1959) 168 CA2d 336]

A credit report and telecredit check

A review of a buyer's creditworthiness requires accurate credit history data on the buyer. **Credit history** obtained from reporting agencies includes *consumer credit reports* and *telecredit checks*.

The **telecredit check** reviews the buyer's check writing history and informs the agent if the buyer has written bad checks in the past.

A **consumer credit report** contains information about a consumer's creditworthiness or credit standing supplied by a consumer credit reporting agency. The credit application form can require the buyer to cover the cost of the credit report.

A credit report does not assure the future performance of the buyer to repay the note, nor does the report demonstrate the buyer's ability to pay.

Properly reviewed, a credit report helps to establish the buyer's past performance in repaying money obligations. Money obligations include amounts owed on loans or financing agreements, on judgments or tax liens, or for late penalty charges on retail and bank credit accounts. The credit report is used by the broker to establish an individual's eligibility for:

- credit to be used for personal, family or household purposes;
- employment purposes; or
- rental of a dwelling unit. [CC §1785.3(c)]

When the carryback transaction involves a carryback note of $50,000 or more, a consumer credit report will also contain information not otherwise available in a credit report, regarding:

- bankruptcies predating the report by more than 14 years;
- paid tax liens or accounts predating the report by more than seven years;
- unlawful detainer (UD) actions where the landlord prevailed; and
- records of criminal activity predating the report by more than seven years.

Persons seeking credit information must identify themselves to the reporting agency, state their purpose for seeking the information and certify the information will be used for no other purpose than what is stated. [CC §1785.14]

An agent seeking information on a buyer will be refused a credit report unless the buyer to be investigated signs a release form for the information, typically included in credit application forms.

The release requirement is waived if the broker is a member of a credit reporting agency's credit association. Credit reports are provided at a preset cost-per-request by the agency to the broker (or agent) member for a one-time membership fee and a minimum monthly billing.

Membership in a credit association requires applicants (brokers or agents) to have their own creditworthiness reviewed by the agency.

CREDIT APPLICATION

Individual

DATE: _____________, 20______, at ____, California.

THIS CREDIT APPLICATION is for the amount of $_______________.

Property address: ____

Received from Applicant(s) $_______________, ☐ cash, or ☐ check, for a consumer credit report which is a non-refundable cost and not a deposit.

Applicant(s):

Applicant One ____

(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)

Social Sec. # ______________________________ Drivers Lic. # ____________________ State______

Applicant Two ____

(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)

Social Sec. # ______________________________ Drivers Lic. # ____________________ State______

Additional Occupant(s): Name ____

Name ____

Rental History: Have you ever been party to an eviction? ☐ Yes ☐ No Filed bankruptcy? ☐ Yes ☐ No

Present Address ____

City ____ Zip ____________________

Length of Residency _____________ Monthly Rent $_______________

Landlord/Agent ____

Address ____

City ________________________________ Zip ____________________ Phone ____________________

Reason for Moving ____ Moving Date ____/____/____

Previous Address ____

City ____ Zip ____________________

Length of Residence _____________ Monthly Rent $_____________

Landlord/Agent ____

Address ____

City ________________________________ Zip ____________________ Phone ____________________

Employment:

Applicant One

Employer ____

Address ____

City ________________________________ Zip ____________________ Phone ____________________

Length of Employment _____________ Position ______________________________ Wages ___________

Pay Period ____________________ Union ____

Previous Employer ____

Address ____

City ________________________________ Zip ____________________ Phone ____________________

Applicant Two

Employer ______

Address ______

City ______ Zip ______ Phone ______

Length of Employment ______ Position ______ Wages ______

Pay Period ______ Union ______

Previous Employer ______

Address ______

City ______ Zip ______ Phone ______

Additional Income Amount $______ Source ______

Recipient ______

General Credit Information:

Automobile One: Make ______

Year ______ Model ______ Lic. #/State ______

Lender ______

Automobile Two: Make ______

Year ______ Model ______ Lic. #/State ______

Lender ______

Bank/branch ______

Check Acc. # ______ Savings Acc. # ______

Bank/branch ______

Check Acc. # ______ Savings Acc. # ______

Credit References:

1. ______

Address ______

Account # ______ Balance due $______ Phone ______

2. ______

Address ______

Account # ______ Balance due $______ Phone ______

Personal Reference ______

Address ______ Phone ______

Personal Reference ______

Address ______ Phone ______

Nearest Relative (name/relationship) ______

Address ______ Phone ______

I/We declare all information given in this application is true and correct. I/We authorize your credit reporting agency to obtain and verify a complete consumer report and supply the information obtained to you. This information is not privileged.

Date: ______, 20______

Name: ______

Signature: ______

(Applicant 1)

Name: ______

Signature: ______

(Applicant 2)

I acknowledge receipt of this credit application and accompanying payment.

Seller or Lender: ______

Signature: ______

Phone: ______

The credit reporting agency will provide the necessary notice to the buyer being investigated.

Although necessary for completing a credit clearance, a credit report does not contain information on the buyer's capacity to pay, called *net worth*, or his propensity to commit a crime.

Financial statements for income and worth

Two financial aspects of a buyer's ability to perform on the carryback note must be investigated:

- the ability of the property's income to cover the **expenses** and carry the **debt service** if it is income producing; and

- the ability of the buyer to personally service any **negative cash flow**, called implicit rent, resulting from the debt burden or lack of rental income or the owner's use of property.

To investigate the property's ability to carry its debt service, the property's income and expenses are analyzed by using the *Annual Property Operating Data Sheet* (APOD). [See **first tuesday** Form 352]

If the property's income is unable to support its operating expenses and debt service, then the seller must look for other abilities of the buyer to carry the negative cash flow caused by the debt.

The buyer's personal capacity to pay is investigated by a review of financial statements delivered by the buyer itemizing his income/expenses and net worth.

The buyer's income includes his base salary, overtime, bonuses, commissions, interest earned, dividends, and rental income. Income from alimony, child support, or other separate maintenance income such as social security and military benefits does not have to be reported on the financial statement if the buyer does not want the income to be considered as available for repayment of the property's debt.

Personal expenses by a buyer are broken down into housing expenses and all other expenses.

The buyer's monthly housing expenses include real estate loan payments, rent, property taxes, association charges, homeowner's/tenant's insurance premiums and utilities.

When housing expenses are added to all other expenses, such as alimony, child support, income taxes and other installment payments such as credit cards, automobiles, etc., the buyer's total expenses are determined. [See **first tuesday** Form 203]

The buyer may be self-employed, or involved in a business, rental or investment activity which provides the buyer with his primary source of income used to establish his creditworthiness. For a self-employed buyer, **financial statements** such as an *operating statement* and *balance sheet* on each business, rental or investment activity are needed to determine any profit or loss and net worth, together with tax returns for at least two years, for confirmation of the financial statements. [See **first tuesday** Forms 207 and 207-1]

Assets of the buyer include cash balances in checking, savings and other accounts receivable. Also included is the current market value of stocks, bonds, personal property, businesses and real estate owned by the buyer. Finally, the current values of vested interests in retirement funds and insurance policies are included.

The buyer's liabilities include the balance owed and monthly payments on credit cards, open credit lines, alimony and child support. Also, loans secured by assets must be listed as liabilities. A buyer's **net worth** is the total value of his assets minus his total debt obligations. Net worth is the bottom line shown on the financial statement identified as the *balance sheet*.

Evaluating credit information

Once a listing agent has obtained a buyer's credit application and financial statements, the data must be evaluated by that agent and the seller of the real estate.

When evaluating the information provided on forms filled out by a buyer, the listing agent and seller must not conduct themselves in a manner which would discriminate against the buyer based on their race, color, religion, sex, sexual orientation, marital status, national origin, ancestry, familial status, source of income or disability of that person. [Calif. Government Code §12955]

The buyer's representations of employment, cash deposits and loans with existing lenders should be verified, as would be done by a mortgage lender. [See **first tuesday** Form 208 through 215-1]

Formulas for determining a buyer's ability to pay for any negative cash flow generated by the purchase of the real estate are structured as expense-to-income ratios. [See **first tuesday** Form 230]

For example, the Department of Housing and Urban Development (HUD) and Federal Housing Administration (FHA) ratio of housing expenses and debt to gross income should be no more than 31%. The ratio of total expenses and all debt to gross income should be no more than 38%.

Institutional lenders generally vary the ratio of housing expenses to gross income to around 30%, and the ratio of total expenses to gross income to around 40%. However, when applying ratios as guidelines to determine a buyer's creditworthiness, each buyer should be treated individually. A buyer who does not meet the expense-to-income ratio is not necessarily an increased credit risk.

Also, the seller may apply an arbitrary ratio or formula, such as a three-to-one *income-to-debt* ratio, as the only basis of determining the buyer's creditworthiness, as long as the ratio is uniformly applied to all transactions. [**Harris** v. **Capital Growth Investors XIV** (1991) 52 C3d 1142]

Income-to-debt ratios assume all non-conforming individuals are unable to pay based on arbitrary mathematical formulas.

Qualifying ratios cause the more complete credit reviews of a prospective buyer to be sacrificed for a quick and easy test of their financial ability. By the use of such qualifying ratios, some buyers who may qualify are not actually good credit risks and some disqualified buyers are actually good credit risks.

Also, requiring employment to be a qualification for prospective buyers unfairly discriminates against people who receive income from investments, annuities, retirement pay, family support or private subsidies.

The carryback seller should review all credit information supplied by the buyer and look for a reason why the buyer qualifies as a good credit risk.

Only after all credit information has been reviewed and creditworthiness has not been established can the seller reasonably cancel the carryback transaction for the buyer's lack of credit.

Chapter 32 — Working the AITD and note

This chapter reviews the advantages of a carryback all-inclusive note and trust deed (AITD), the terms to be negotiated and the forms to be used.

Flexible carryback financing

As a *debt instrument* and *security device* for the credit sale of encumbered real estate, the all-inclusive note and trust deed (AITD) provides agents, sellers and buyers with the flexibility needed during periods of tightened availability of mortgage funds to finance the **balance of a sales price** remaining unpaid after a down payment.

For a buyer, the AITD note carried back by a seller is all the financing needed to acquire encumbered real estate on making a down payment. The principal amount of the AITD note includes:

- the seller's **remaining unpaid equity** in the property; and
- the **unpaid balance** on the existing loan which will remain of record, called the *wrapped loan* or *underlying loan*.

The buyer makes monthly payments to the seller on the AITD note. In turn, the seller makes monthly payments to the underlying lender.

The advantages of an AITD note over a regular second trust deed note are mainly felt by the seller. However, the buyer, seller and lender benefit since the buyer does not become personally obligated for the wrapped loan and the assumption process is avoided by all involved, including the lender.

For the benefit of the seller, the AITD note:

- **allows a greater yield** than could ordinarily be negotiated on a regular second trust deed note, a financial advantage due to the AITD note's *overriding interest rate* feature;
- **reduces the risk of loss** due to a default on the underlying loan since the seller remains primarily responsible for payments on the underlying loan;
- **defers profit tax liability** for a greater percentage of the transaction's profit taxes since an AITD note increases the percentage of profit allocated to the principal in the carryback;
- **supports the price** sought by the seller by providing financing; and
- **provides for a trustee's foreclosure** on the buyer's default, unlike other wraparound security devices, such as land sales contracts and purchase/lease-option agreements which require a judicial foreclosure (unless they contain a power- of-sale provision).

As a benefit to the buyer, the AITD note provides more simplicity and flexibility than conventional or government insured loans, since:

- the interest rate and payment schedules are **fully negotiable** and not tied to secondary money market standards;
- the carryback seller is less concerned with **creditworthiness** and income ratios than standardized institutional lenders due to the seller's knowledge of the property and a more personal relationship with the buyer (borrower);
- the buyer makes payments on only one debt, the AITD note; and
- no third-party lender fees are required, such as points, garbage fees, private mortgage insurance (PMI), assumption fees or a separate (and expensive for value received) lender's American Land Title Association (ALTA) title insurance policy.

AITD concepts

An all-inclusive trust deed (AITD) is always a **junior trust deed**, usually a second, subordinate to a pre-existing, underlying first trust deed lien. Legally, the AITD has the same function as a regular trust deed. An AITD is physically a regular trust deed form, with the addition of an AITD addendum covering the disclosures and accounting for the financial aspects of the all-inclusive wraparound device.

Land sales contracts and lease-option sales are also all-inclusive security devices and they exhibit the same wraparound debtor/creditor features as an AITD. In all three — AITD, land sales contract and lease-option sale — the seller has sold the property and remains responsible for payments on the underlying loan while receiving installments from the buyer. Income and property tax results for each device are treated the same by all government agencies.

AITD terms

The terms negotiated for payment of the sales price when the seller carries back an all-inclusive trust deed (AITD) note include five variables:

- the down payment;
- the amount of the AITD note;
- the interest rate;
- the periodic (monthly) payments; and
- the due date.

Down payment

The down payment in an all-inclusive trust deed (AITD) carryback note transaction is handled no differently than on any other method of carryback or conventional financing, such as a regular first or second

trust deed, land sales contract or lease-option sale financing. The amount of the down payment is fully negotiable between a buyer and seller, and can range from zero to the seller's entire equity in the property.

The prudent carryback seller will require a down payment of no less than 10% to 20% of the sales price depending on whether the property is sold as a buyer-occupied single family residence (SFR) or income producing property. The smaller the down payment, the greater the risk of loss for the seller should the buyer default and the property be repossessed and resold. The risk of loss created by a low down payment is covered financially by:

- an increase in the price or interest rate, or both;
- guarantee by a person other than a signer of the note;
- cross collateralization by a lien on additional property; or
- the bifurcation of the carryback debt into separate secured and unsecured debts.

Amount of the note

The distinguishing characteristic of the all- inclusive trust deed (AITD) note is its *face amount*. The **face amount** of the AITD note includes the unpaid balance on any underlying encumbrances which remain the responsibility of the seller to pay, **plus** the seller's equity remaining unpaid after a down payment. Viewed another way, the AITD note is the entire balance of the sales price remaining after the down payment. [See Form 421 in Chapter 34]

At first glance, the total dollar amount of the debts secured by the underlying trust deed and the all-inclusive carryback trust deed appear to over-encumber the property.

However, the amount of the AITD note **wraps around** and is **inclusive** of the underlying loan balance. Thus, the separate trust deed balances cannot be added together to determine the total dollar amount of encumbrances on the property. The amount of the AITD note is most frequently the total amount owed on **all** encumbrances.

For example, property encumbered by a $60,000 first trust deed is sold for $100,000 with a $30,000 down payment. An AITD note is carried back for $70,000, the amount remaining unpaid on the purchase price. The buyer does not assume or otherwise agree to pay the first trust deed. Collectively, the amounts secured by the two trust deeds total $130,000, yet the amount required to clear title of both trust deeds is controlled by provisions in the AITD addendum and is only $70,000, the amount of the AITD note.

Conversely, a **regular** trust deed note carried back as a second for the balance of the seller's equity (after the down payment) would have in this case been for $10,000, with the buyer assuming the $60,000 first trust deed, for an aggregate debt of $70,000.

The minimum dollar amount the seller can carry back on an AITD is the total amount of the underlying loans for which the seller remains responsible. The AITD note must be mathematically structured so that it has a remaining **principal balance** at all times equal to or greater than the remaining balance on the wrapped loans.

However, an AITD need not include all pre-existing trust deeds or other loans recorded against the property sold. The AITD may be a third trust deed which wraps only the second and not the first, or vice versa.

For example, the buyer takes over payments on the existing first trust deed loan which is not included in the AITD amount, with the seller remaining responsible for the second lien (which may be a tax, a judgment lien, or a loan with an interest rate unacceptable to the buyer).

When only one of two existing loans is wrapped, the dollar amount of the AITD note is for the remaining balance of the purchase price after deducting both the down payment and the balance remaining on the one loan taken over by the buyer.

The interest in alternatives

Use of an all-inclusive note and trust deed (AITD) by a seller can make attractive financing for buyers during periods of high interest rates by offering a **below-market rate**, whether or not the underlying note rate is below market.

For the seller, the interest rate on the AITD note will preferably, but will not always, equal or exceed the rate on the underlying note.

In this respect, the AITD rate is said to *override* the rate on the underlying trust deed note. The override is the difference between the interest rate on the underlying trust deed note and the higher rate negotiated for the AITD note.

For example, an AITD note with a 8% rate which wraps a first trust deed note at 5% gives the seller a 3% interest **override** on the underlying loan balance.

The override is the financial advantage available to the carryback seller when using an AITD, as it can greatly increase the yield on his equity in the AITD note. [See Chapter 21]

If the interest rate on the underlying loan **exceeds** the interest rate on the AITD, the seller's equity in the AITD is said to *burn-off* bit by bit, shrinking daily as interest accrues in dissimilar amounts on each trust deed note.

This principal burn-off reduces the seller's equity in the AITD. More importantly, the AITD note balance will reduce faster than the balance on the underlying loan, converting cash received as principal payments on the AITD into interest paid on the wrapped loan. As a result, a due date on the AITD must be set for payoff before the balance on the AITD note sinks below the balance on the wrapped loan, called a *crossover*.

Wrapping a variable rate loan

The seller wrapping a variable/adjustable rate mortgage (ARM) with an all-inclusive note and trust deed (AITD) should conform the interest rate provisions in the AITD note to the rate adjustment provisions in the underlying ARM. The same index, adjustment periods, floor and ceiling rates, and payment schedules should be included in the AITD note, making the AITD an ARM.

For example, an owner decides to sell real estate encumbered by an ARM. The ARM has a note rate periodically reset in accordance with the 11th District cost-of-funds index plus a margin rate of 2.5%. By using the same index and a **margin equal or greater** than on the underlying loan, the seller will receive sufficient interest to service the first trust deed without reducing the seller's return on the all-inclusive ARM, resulting in no **principal burn off**.

When the seller uses the same index on the AITD note as the index used on the underlying loan, but negotiates a greater margin, the seller receives additional **overriding interest** on the portion of the AITD note representing the balance on the underlying loan.

A carryback seller should not use a different index on the all-inclusive ARM than the index used on the underlying loan. If a different index is used, the index for the carryback could fall while the index on the underlying loan rises, leaving the seller to pay the difference.

Also, a seller can wrap a fixed-rate loan by carrying back an all-inclusive ARM. The adjustable rate provision included in the AITD note would set the life-of-loan *floor rate* at no less than the fixed rate on the underlying loan. Thus, the seller prevents the interest rate on the all-inclusive ARM from falling below the rate on the underlying fixed-rate loan. [See Chapter 11]

Payments and contract collection

In a typical all-inclusive note and trust deed (AITD) transaction, the buyer makes installment payments on the AITD note directly to a seller. The seller then makes the scheduled payments owed to the underlying senior lender. The seller retains the difference as his net cash flow on the AITD note.

The seller can enter into *contract collection* account with a servicing agent to receive payments and make disbursements to the underlying lender. Under contract collection, a bank, thrift, escrow or broker will collect and disburse the monthly payments called for in the AITD note. [See **first tuesday** Form 237]

Contract collection is convenient. However, if the seller and the buyer **mutually agree** that the seller will place the AITD note on contract collection, the agreement will severely reduce the deferral of profit tax on the installment sale. The collection agent is deemed to be the agent of the buyer when agreed to by the buyer and the seller. When payments are made by the buyer's agent, the responsibility for payments on the underlying loan is attributed to the buyer.

Due to the shift in responsibility created by a mutually agreed to contract collection account, the seller has **debt relief**, increasing the profit-to-equity ratio on the installment sale and increasing the percentage of down payment and principal payments reported annually as profit. [**Goodman** v. **Commissioner of Internal Revenue** (1980) 74 TC 684]

The buyer's monthly payments on the AITD note may be in any amount. However, prudence suggests the payments will be no less than the amount the seller must pay on the underlying note, even if good reason exists for a lesser payment.

Also, the flexibility available with the AITD note allows for payment schedules to be negotiated which are attractive to buyers.

For example, young buyers, whose rising incomes will allow them to make larger payments in the future, might be able to purchase the seller's property if a *graduated payment program* allows them to initially afford payments to buy the property.

Graduated monthly payments allow buyers to make monthly payments which start out low, but gradually increase from year to year. For instance, a buyer who cannot currently afford what should be a monthly AITD payment of $2,000 could offer to pay $1,400 monthly for the first year. With the agreement of the buyer and seller, the monthly payments could be increased $200 annually, until the full $2,000 amount needed to amortize the AITD is reached.

However, the low monthly payments may be insufficient to cover the accrual of a fixed rate of interest on the AITD note. A provision can be included in the note calling for any accrued and unpaid interest to be added to the principal, called *compounding*.

Thus, until the buyer's monthly payments increase enough to cover the accruing interest, the principal amount of the note will increase, an accounting situation called *negative amortization*.

Rather than adding interest to the principal, a provision for an additional installment could be negotiated and added into the note calling for an additional payment on a future date of all accrued interest which remains unpaid. For an alternative to **negative amortization** under the fixed rate, a *graduated rate* of interest could be charged which is consistent with the graduated payment schedule.

Another tax consideration for carryback sellers is the use of a *prepayment penalty* provision to induce the buyer to pay no more than the amount of the scheduled monthly payments for an agreed-to period of years. Any early payoff of additional principal during the enforcement period will include a prepayment penalty. Prepayment penalties are limited on one-to-four unit residential properties. [See Chapter 13]

A prepayment penalty should be a sufficient amount to provide funds for the seller (on other than one-to-four units) to cover the tax liability incurred on the premature termination of the installment sale due to an early payoff. [See Chapter 13]

Payoff amounts vary

Two types of all-inclusive trust deeds (AITDs) exist, including:

- an *equity payoff* AITD [See Form 442 in Chapter 34]; and
- a *full payoff* AITD. [See Form 443 in Chapter 34]

With an **equity payoff** AITD, reconveyance occurs when a seller's equity in the AITD — the principal amount of the AITD note remaining after deducting the underlying loan balance — is fully paid. [See Form 442 in Chapter 34]

Once the seller receives the payoff for the equity amount in his AITD and reconveys, the buyer becomes primarily responsible for installment payments on the underlying trust deed note. The underlying trust deed is not paid off and remains of record, the buyer having originally taken title subject to the loan.

Full payoff AITDs require payment of the entire balance on the AITD note — which includes amounts owed on the underlying loan — before reconveyance can occur. Thus, both the AITD and the underlying trust deed are fully satisfied and reconveyed on payoff of the AITD. The full payoff AITD is less financially flexible for the buyer when arranging for a payoff. [See Form 443 in Chapter 34]

Taxwise, the full payoff AITD is preferable for the seller. The full payoff AITD note, without a contract collection provision, provides for no debt relief at any time. The buyer can never take over the responsibility for the underlying loan, even on final payoff and reconveyance of the AITD. Thus, the full payoff AITD allows the seller to use the installment sales method of income tax reporting without the issue of debt relief ever arising. [See Chapter 32]

The due date for an AITD note can be set at any length of time, ranging from the first of the next calendar year to 15 years or more. However, the due date of the AITD note should fall on or before any due date on the underlying loan or a crossover in principle balances.

For example, if an underlying loan, perhaps a second, is due in three years and the AITD in five, the seller will be required to pay off the underlying lender before he is due to be paid off on the AITD.

In this scenario, the seller could pass the payoff burden to the buyer by including a special additional installment on the AITD note. The payment would be sufficient in time and amount to meet the final/balloon payment on the underlying loan. The alternative is to set the due date on the AITD to no later than the date of the final/balloon payment on the underlying loan.

Also, an amortization schedule which reduces the AITD note balance to an amount equal to the wrapped loan requires a due date on or before the date by which both notes will have the same remaining principal balance, before the crossover. Thus, the seller avoids liability for a reduction in the AITD note below the amount of the wrapped loan.

Pass-through clause protection

An all-inclusive trust deed (AITD) also contains *pass-through provisions* to cover charges demanded by the underlying lender. [See Forms 442 §5 and 443 §6 in Chapter 34]

For instance, the buyer may wish to refinance and pay off the AITD note and the underlying loan before they come due. With a **pass- through provision** in the AITD addendum, the buyer will fund any prepayment penalty the underlying lender is entitled to for early payoff, not the carryback seller, even though the seller is primarily responsible for paying principal and interest on the underlying debt.

Also, if the underlying lender demands payment of any late charges, future advances or the entire loan balance brought about by the buyer's use of his ownership, the payment of the demands is passed through to the buyer.

Due-on interference hazards

A lender holding a trust deed which contains a due-on clause can call the loan balance due on the transfer of almost any interest in the property. The due-on clause is called an *alienation clause* since it is triggered by transfers, and the call that results in the note being fully due and payable is referred to as an *acceleration* of the note balance. [See Chapter 17]

The **due-on clause** in an all-inclusive trust deed (AITD) is triggered by:

- any conveyance of ownership, including land sales contracts;
- origination (except home equity loans) or foreclosure of junior trust deeds on the property; or
- the creation of a lease for more than three years, or any lease with an option to buy. [12 Code of Federal Regulations §591.2(b); see Chapter 21]

The carryback AITD transaction involves both a sale (the grant deed) and a further encumbrance (the trust deed).

Thus, an AITD transaction triggers the due-on clause in any underlying trust deed which allows the lender holding that due-on trust deed to:

- call or recast the loan, unless they have given written consent to the sale; or

- fail to timely act on the right to call the loan after notice of the transaction, called a *waiver by consent*.

When current market interest rates are high and the AITD is most beneficial to both the buyer and seller, the senior trust deed lender is likely to call the underlying loan due on sale. Alternatively, the lender might demand the loan be recast at current market rates (including modified payments to retain the same amortization period and fees for doing so), or the lender may do nothing at all.

Consider an AITD buyer who takes title to the property **subject to** the underlying loan — the buyer **does not assume** the seller's obligation to pay the loan at the time of the sale. No lender consent to the carryback sale is sought or obtained by the seller.

Under the terms of the AITD, the seller agrees to hold the buyer harmless from all obligations which exist on the underlying loan. [See Form 442 §1 and Form 443 §1 in Chapter 34]

Thus, the buyer is **held harmless** (by the seller) against any activities of the underlying lender, unless:

- the **buyer interferes** by triggering the due-on clause through further encumbrance, long-term lease, resale, waste, etc; or

- a **pass-through provision** in the AITD shifts the due-on-sale burden to the buyer, as it does to late charges, prepayment penalties or future advances.

Payments made as payments received

A seller's primary duty is to make all the payments due on the underlying loan, as long as the all-inclusive trust deed (AITD) remains of record and the buyer is not in default.

If a buyer fails to make payments on the AITD note, the seller is under no legal obligation to forward his own funds to the underlying lender, or to protect the property from a foreclosure under the first trust deed.

Even without the obligation to keep the first trust deed current, the AITD seller may feel compelled by the buyer's default to advance funds to keep the underlying trust deed current. If he does not, he risks allowing his AITD to be wiped out by the underlying lender's foreclosure.

If the underlying lender calls the loan based on the AITD transaction, the seller may be forced to use his own funds or borrow against other assets (or collateralize the AITD) to pay off the lender. Thus, the AITD seller must have an agreement with the buyer to cooperate with the seller should the first trust deed be called due and it becomes necessary for the buyer to sign documents to refinance the real estate to fund the payoff.

If possible, prior arrangements should be made with senior lenders to prevent due-on enforcement during the term of the AITD, called a *reverse assumption*. [See Chapter 18]

AITD documentation

The all-inclusive trust deed (AITD) transaction should be documented:

- between a buyer and seller in a purchase agreement, escrow instructions, grant deed, trust deed and note;

- between a seller and lender in a written due-on waiver and any modification of the underlying note agreed-to with the lender for consent; and

- through escrow, by the buyer depositing the downpayment funds and the all-inclusive note and trust deed, and the seller depositing his grant deed.

Agents must make full disclosure to the buyer and the seller about the terms of the carryback and the underlying financing. Disclosure is accomplished in part by use of the AITD addendum. Further, a carryback financing disclosure form with statutorily mandated content is to be used on carryback sales of one-to-four unit residential property and, as good practice, on the carryback sale of all other types of property. [See Chapter 29]

Buyer NODq protection

A buyer and the buyer's agent must be sure the terms of the all-inclusive note and trust deed (AITD) are consistent with the underlying senior note and trust deed it wraps.

To assure consistency, escrow should be instructed to order a *beneficiary statement* from the existing trust deed lender. A lender's **beneficiary statement** confirms the terms of the underlying encumbrance are as represented by the seller. The statement enables the buyer to confirm the consistency of the terms in the underlying loan and the AITD. [See Form 429 in Chapter 18]

The buyer should also consider having the seller agree to **record and serve** the underlying lender with a *Request for Notice of Default* and *Notice of Delinquency* (NODq) on the underlying trust deeds. [See Form 412 in Chapter 48; see Chapter 4]

The request for an NODq assures the buyer he will promptly learn of any failure by the carryback seller to make payments to senior lienholders. [Calif. Civil Code §§2924b, 2924e]

Editor's note — A carryback seller who fails to pass AITD payments on to the wrapped lender exposes himself to criminal sanctions.

The PIQWOP risks in a blanket encumbrance

Finally, a buyer or his agent should check the preliminary title report to find out if the underlying trust deed is a **blanket encumbrance** which also affects property other than the property in question.

All-inclusive trust deeds (AITDs) are sometimes used by undercapitalized developers and land sales promoters. With the AITD, they can finance the sale of real estate lots which have been cut out of a larger parcel when the larger parcel is encumbered by a blanket trust deed which may lack a partial release clause.

For their purpose, these developers and promoters use an AITD which only discloses that "underlying loans may or may not exist."

Typically, in these cases of blanket encumbrances, no disclosure is made of the amount or terms of the underlying loan, nor of the existence of the blanket trust deed on the *parcel in question with other parcels* (PIQWOP).

If the seller defaults on a blanket trust deed which lacks a partial release clause, the buyer of a parcel of real estate on an AITD would have to pay off or refinance the entire blanket trust deed to protect himself. Paying off or refinancing the entire blanket trust deed is an economically unlikely possibility when, as in most cases, the underlying loan balance exceeds the AITD balance (and the price paid for the individual lot). [**Drake** v. **Martin** (1994) 30 CA4th 984]

Chapter 33 — The AITD's leveraged yield

This chapter evaluates the annual yield a seller receives on his equity in an all-inclusive note, and addresses due date aspects of a reverse all-inclusive trust deed.

The wraparound multiplier effect

Consider a property encumbered by an existing trust deed which secures a note with a balance of $600,000, payable monthly, including 7% interest, until fully amortized in 26 years.

The owner of the property would like to cash out his equity without reducing the sales price of the property to below $1,000,000.

However, an inflationary economy and an over-active real estate market have brought on a corrective credit crunch, making it difficult for buyers with modest down payments to obtain financing from conventional lenders.

Accordingly, the owner agrees to list the property on sales terms which include a 20% down payment and a carryback note for the **balance of the purchase price**, called an *all-inclusive note and trust deed* (AITD).

The AITD will "wrap" the existing **underlying loan** encumbering the seller's property. Specifically, the principal amount of the AITD note will include the amount of the $600,000 principal balance remaining on the underlying loan.

AITD equity

Consider an example where a seller carries back an all-inclusive trust deed (AITD) note for $800,000, bearing an 8% interest rate with monthly payments amortized over 30 years, all due in seven years. The **seller's equity** in the AITD note is the difference between the $800,000 AITD note and the $600,000 balance remaining on the first trust deed note — a $200,000 equity in the AITD at the time of closing.

The seller receives 8% interest on the entire amount of the $800,000 AITD note. In turn, the seller pays the underlying lender 7% interest on the $600,000 first trust deed loan.

The AITD interest override

At a time when interest rates for mortgages are higher than rates charged during the prior 18 to 24 months, when the seller recorded his loan, a carryback seller can offer a below market rate on an all-inclusive trust deed (AITD) note and actually yield a greater return on his equity in the AITD note than currently charged by private money lenders.

The spread between the interest rate on an underlying loan and the AITD note is called an *overriding* interest rate. The AITD has an interest rate override on the underlying loan (in our example 1%; 8% AITD minus 7% loan).

The spread in the **override** between the interest rates accrues to the benefit of the seller. The interest rate override raises the **effective yield** on the seller equity in the AITD above the AITD note rate, the result

of *leveraging* (ratio of the underlying loan balance to the AITD equity; three to one). However, this **leveraging** ability is hindered by the seller's need for the first trust deed lender's consent under any due-on clause in the wrapped trust deed.

For the carryback seller, the AITD with its interest override can be compared to a private lender borrowing money from a bank at one rate (the rate on the underlying trust deed loan) and lending the funds to buyers of real estate at a higher rate (the rate on the AITD), as most lenders do.

In our example, the seller receives annual interest on his AITD of $64,000 (8% of $800,000). In turn, he pays the underlying lender $42,000 in interest (7% of $600,000). Thus, the seller's net annual interest income equals $22,000 during the first 12 months.

The $22,000 net interest income is the seller's annual interest income earned on his $200,000 AITD equity, resulting in an 11% yield.

The AITD equity allows the seller to receive a greater return than the trust deed note rate, called the *effective rate of return* on the AITD note.

Editor's note — The equity leverage on the 1% override on the existing debt is 600,000:200,000, or 3:1. Hence, the 1% override becomes an additional 3% yield on the equity in the AITD — a yield added to the 8% AITD note rate on the $200,000 equity in the AITD. Thus, the effective rate of return on the $200,000 equity in the AITD note is 11% (3% plus 8%).

The effective rate of return

The **effective rate of return** on a seller's equity in an all-inclusive trust deed (AITD) note is calculated using the principal amount of the underlying trust deed note, the equity amount in the AITD note and the interest rate spread between these two notes.

The mathematical formula to use with a financial calculator is:

- enter the amount of the underlying loan balance;
- ÷ equity in the AITD note;
- x the interest rate spread between the underlying loan and the AITD note;
- \+ the interest rate on the AITD note;
- = the yield on equity in the AITD note.

Thus, the seller's yield on the AITD equity in our previous example is:

- $600,000 underlying loan balance;
- ÷ $200,000 AITD equity;
- x 1% interest override;
- \+ 8% AITD note rate;

- = 11% yield on AITD equity.

The $800,000 AITD note carried back at an interest rate of 8% gives the seller the same yield as though the buyer assumed the underlying loan and executed a seller carryback note for $200,000 at 11%.

However, the AITD gives the seller a great psychological advantage over the typical buyer. With an AITD, the buyer can boast about the lucrative financing he negotiated with the seller.

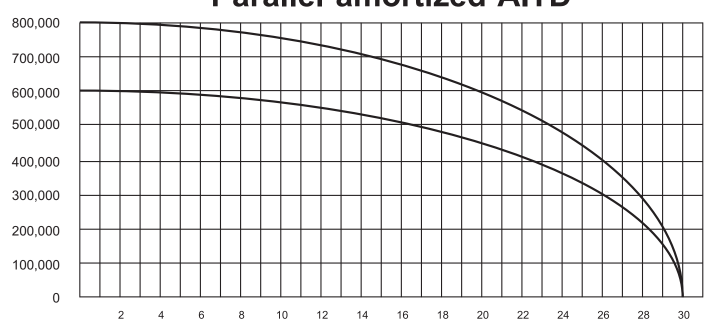
The buyer has obtained maximum financing and pays 8% interest, with no points or garbage fees. Conversely, if the buyer executed a second trust deed note for $200,000 at 11% interest, he would have nothing to brag about, even though he would have taken over a first trust deed note at 7% and be paying the same overall amount of annual interest on the two encumbrances as he would have at the 8% rate on the AITD note.

Conflicting amortization periods

The yield calculation for the effective rate of return on an overriding all-inclusive trust deed (AITD) note sets the yield at the time of sale. However, the **effective interest yield** on the AITD note will vary following each payment throughout the life of the AITD.

Figure 1

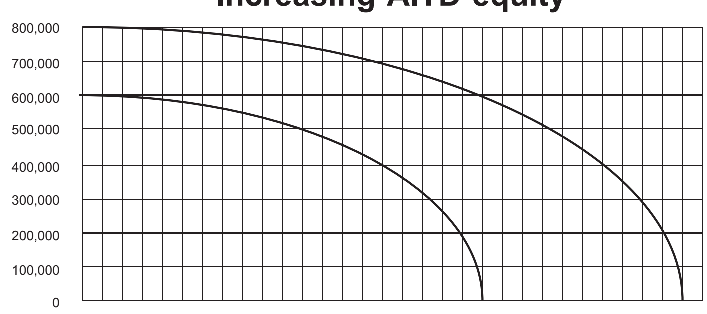
Parallel amortized AITD



An $800,000 AITD and a $600,000 underlying loan are both amortized over 30 years. The result is an AITD equity which gradually increases as a percentage of the total AITD throughout the term of the AITD.

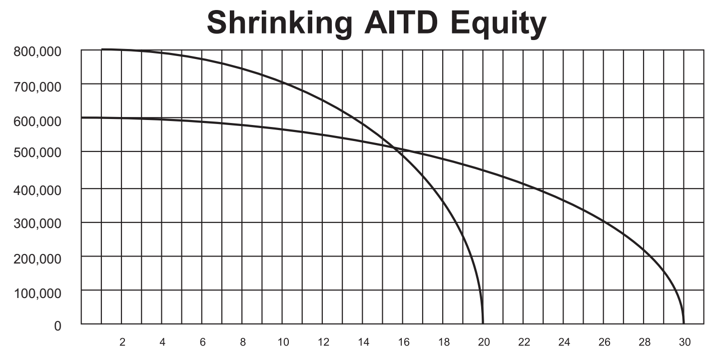
Figure 2

Increasing AITD equity



An $800,000 AITD amortized over 30 years wraps a $600,000 underlying loan amortized over 20 years. The result is AITD equity is increasing. The AITD equity increased from 25% of the AITD by year 18. Thus by year 20, the seller's AITD equity yield is 8%, a decrease from the original 11%.

Figure 3



An $800,000 AITD amortized over 20 years wraps a $600,000 underlying loan amortized over 30 years. Since the AITD equity is shrinking, the seller should demand a payoff of the AITD before year 12, since at this point the AITD and the underlying loan balance would cross over and the AITD would have a negative equity which must be avoided.

When the amortization periods for both the AITD note and the underlying loan are the same, the amount of equity in the AITD note decreases gradually until the principal on the AITD and the underlying note is fully paid.

With the amortization periods the same on both notes, the effective *rate of return* **decreases gradually** over the life of the AITD since the ratio of the AITD equity to the balance remaining on the underlying loan decreases. [See Figure 1]

More dramatically, when the underlying loan amortizes over a **shorter period** of time than the AITD note, the *equity* in the AITD note increases from month to month while its annual **rate of return decreases**. Earlier principal payoff on the underlying loan decreases the AITD leverage, causing the seller's equity in the remaining balance on the AITD note to increase and the effective rate of return to decrease until the underlying loan is fully paid. [See Figure 2]

Shrinking equity in the AITD

When the underlying loan is amortized over a longer period of time than the amortization period for the all-inclusive trust deed (AITD), the equity in the AITD decreases and the effective **rate of return increases**. The principal due on the AITD note is amortized (by payments) over a shorter period than the underlying loan.

Thus, the seller's equity in the AITD note decreases from month to month, until **no equity remains** in the AITD. Consequently, the increasing leverage causes the effective yield on the seller's equity in the AITD to increase from month to month, until there is a **cross-over** in the note balances. [See Figure 3]

Accordingly, the AITD note which produces a **shrinking AITD equity** must contain a **due date** by which it will be satisfied and reconveyed. The due date must be scheduled to occur before the date the AITD balance falls below the remaining balance on the underlying loan.

Further, the AITD must be satisfied and reconveyed prior to the cross-over of note balances. If not, the seller is **contractually liable** for the amount of the underlying loan which exceeds the balance of the AITD note when the AITD note is eventually satisfied. [See Figure 3]

Yield when wrapping two loans

Occasionally, a seller's property is encumbered by more than one loan. Two or more loans can be wrapped by an all-inclusive trust deed (AITD) and their principal balances included in the amount of the AITD note. Thus, a buyer only makes one payment each month, which is paid to the seller. In turn, the seller makes two payments, one on each of the wrapped loans.

The percentage yield on the AITD equity when wrapping two (or more) loans is calculated by dividing the dollar amount of the AITD equity into the seller's *net annual interest income*. The seller's **net annual interest income** is the total of the interest earned on the AITD minus all interest expenses incurred on the wrapped loans.

For example, a seller carries back an AITD which wraps two loans totaling $750,000, a first trust deed loan for $600,000 at 9% interest, and a second loan for $150,000 at 10 ½% interest.

The seller carries a $1,000,000 AITD at 12%.

The equity in the AITD note is $250,000 ($1,000,000 AITD minus the $750,000 due on the two wrapped loans).

The net interest income the seller receives is the difference between the $120,000 interest received on the AITD ($1,000,000 x 12%), and the $69,750 interest expense paid on the underlying first and second trust deed loans ($600,000 x 9% plus $150,000 x 10 ½%).

Thus, the seller's net annual interest income at the time of the AITD's creation is $5,025. The effective yield on the seller's equity in the AITD is calculated as the net interest income divided by the dollar amount of the equity in the AITD note.

Thus, the yield on the AITD note is:

$50,025 ÷ $250,000 = 20% effective yield.

The Reverse AITD

The interest rate on an all-inclusive trust deed (AITD) note usually is negotiated at a rate higher than the interest rate on the underlying loan, called an *override rate* or *spread*.

However, sellers occasionally have the incentive to carry back an AITD note with a lower interest rate than the rate on the underlying loan, called a *reverse rate of return* or *negative spread*.

To motivate buyers to pay the price sought by the seller for the property during a depressed seller's market, the seller can offer AITD financing at a **lower-than-market interest rate**.

For example, consider property offered for sale which is encumbered with an $800,000 loan bearing interest at the current market rate of 9%. The loan is payable monthly, amortized over the next 26 years.

To attract buyers to cash out his $200,000 equity in the property, the seller will carryback an $800,000 AITD note at an interest rate of 6%, a sort of **teaser rate** used to attract prospective buyers. The AITD rate, being lower than the rate on the underlying loan, called a *negative spread*, has the opposite mathematical effect from an overriding rate. Thus, the seller incurs monthly interest expense in excess of the interest income on the AITD note at the annual rate of 3%.

To accommodate the 3% negative spread, the price for the property is increased by approximately 15% above its current cash market value (five year x 3% reverse spread). The down payment will remain the same. The 15% increase in the purchase price will be reflected in the AITD amount and cover the 3% reverse interest rate charged by the seller until the AITD is due in five years. The AITD note will contain a five year due date so the seller will avoid incurring a *negative equity* in the AITD.

The price paid by a buyer is adjusted upward to offset the seller's *opportunity cost* of financing the sale by extending credit at a lower-than-market interest rate. Financially, what occurs is a one-time "buy down" of the interest rate for the five year life of the AITD note, paid for by the increased price.

Of course, the buyer will pay the exact same amount of dollars for financing and acquisition costs by the end of his first five years of ownership, including payoff amounts, as he would have paid had he assumed the underlying 9% loan and paid a price for the property of $1,000,000 with a $200,000 down payment.

At the end of five years, the final/balloon payment on the AITD will be the same amount as the balance remaining on the wrapped loan.

The entire AITD equity *burns off* gradually, decreasing to zero by the end of the five year period.

Since a default on the final/balloon payment due in five years is foreseeable, the AITD note with a negative interest rate spread must provide for a **default interest rate** of at least the rate on the underlying loan (9% in our example). [See Form 418-1 in Chapter 11]

Negative amortization

During periods of economic recession when new conventional financing is not available at interest rates which will support past property values and help finance the sale of real estate, a seller seeking to successfully encourage buyers to purchase his property must be willing to either accept a reduced purchase price or carry the financing at a lower-than-market interest rate.

Carryback financing facilitates a sale by supporting the seller's elevated price with a lower interest rate and an accommodating payment schedule which are readily acceptable by buyers.

To attract more creditworthy buyers, the seller can agree to a **graduated payment** schedule over a two or three year period to reduce the carrying costs of ownership and better qualify the property for acquisition by a buyer.

For example, a seller's monthly payment on his existing loan is $6,500. To reduce a perspective buyer's initial costs of ownership, the seller carries back an all-inclusive trust deed (AITD) note calling for the same ($6,500) monthly payment for the first year, sufficient in amount to cover the seller's payments due on the underlying loan.

The payments will rise on the AITD note each year until a payment schedule is reached which will amortize the balance over the desired number of years.

The seller does not need to periodically adjust the rate of interest on the AITD note. However, during the first year(s) of payments, he will be accepting a payment in an amount which will not cover the interest accruing each month, a situation called *negative amortization*.

Here, the accrued and unpaid monthly interest on the AITD note may be added by agreement to the note's principal balance each month. The unpaid interest will then earn interest as principal, called *compound interest*.

The graduated AITD

Instead of a fixed rate of interest coupled with a negative amortization, a seller might offer an all-inclusive trust deed (AITD) with an annually escalating rate of *interest and payment* schedule to attract buyers.

Being comparable to the 3-2-1 loan buy-down programs used by builders and other informed sellers, the terms of a graduated AITD note for the first three years reduces the present cash value of the AITD note by about 5% of its principal balance, a cost which is passed on to the buyer through a higher-than-market sales price.

Again, the seller carryback financing is facilitating the sale and supporting the price. Without carryback financing, either the value will drop or the property will not sell due to tight mortgage money conditions and uncertainty of buyers about the immediate future at the time of sale.

A seller can agree to a reduced interest rate on the AITD during the first few years after the sale. For example, the AITD interest could start at a low initial (teaser) rate and be adjusted upward periodically, annually or semiannually, by one-half or one percent until a fixed rate for the remainder of the AITD term is reached. Payments would start low and be adjusted upward to maintain the original amortization period, called a *graduated payment note*.

The **graduated AITD** allows property to be sold without the seller lowering the asking price. For example, a seller wants an interest rate of 9% on carryback AITD financing due in seven years.

For the seller to maintain his sales price and accommodate the buyer, he agrees to a 6% interest rate during the first year after the sale with monthly payments amortized over 30 years.

Further, on each anniversary of the AITD note, the interest rate is increased by 1% until the AITD interest rate is 9%. Thus, the interest rate on the AITD note is:

- 6% in the first year;
- 7% in the second year;
- 8% in the third year; and
- 9% fixed in the fourth year and for the remaining life of the AITD.

The amount of the AITD note payments graduate annually, reamortized over the remaining life of the AITD on each interest rate adjustment. Thus, negative amortization, with its build up of principal, is avoided by all.

Chapter 34 — The all-inclusive note and trust deed rider

This chapter explains the preparation and relationship between the all-inclusive note and the two addenda which convert a trust deed to an all-inclusive trust deed (AITD).

Negotiating interest rates and payments

An all-inclusive trust deed (AITD) note, also called a *wraparound note* or *overriding note*, is evidence of an **installment debt** created to pay the balance due on the buyer's purchase price of real estate after a down payment. In turn, a seller retains responsibility for, and makes payments on, the existing trust deed note encumbering the property he sold.

The interest rate charged by the seller carrying back an AITD with a five-to ten-year due date is usually comparable to rates available on new first trust deed financing.

Conversely, the interest rate charged on carryback notes with due dates exceeding five to ten years usually exceeds market rates for new loans. However, rates charged by carryback sellers do vary greatly with the needs and expectations of the individuals in each transaction.

Also, sellers rarely seek points or origination fees as compensation for providing the buyer with AITD financing in addition to an interest rate override on the wrapped loan.

Waiver of due-on clause

The all-inclusive trust deed (AITD) carryback seller agreeing to wrap a first trust deed containing a due-on clause must, during negotiations, anticipate the lender's demand to recast its note by increasing the interest rate, payment amounts or due date.

Prior to closing the carryback sale, the seller may want the lender to waive the lender's right to call the loan on the sale and carryback of the AITD, called a *reverse assumption*.

In exchange for the seller agreeing to a modification of the note and the payment of a fee, the seller will obtain the lender's written waiver of the due-on clause. [See Form 410 in Chapter 28]

Thus, instead of the buyer assuming the first trust deed note, the carryback seller remains responsible for payment of the note.

Provisions of the all-inclusive promissory note

Editor's note — ***first tuesday*** *Form 421 is not created for use without major modification when wrapping a variable rate loan. [See Form 433 in Chapter 7; see Chapter 6]*

When the underlying loan is an adjustable rate mortgage (ARM), the seller must make sure the all-inclusive trust deed (AITD) is adjusted concurrent with adjustments in the underlying ARM to avoid a negative cash flow. Disclosures are required on ARM AITDs on one-to-four unit residential property sales.

The all-inclusive note is used with either the **equity payoff** or **full payoff** varieties of all-inclusive addenda to a regular trust deed.

Preparing the all-inclusive trust deed note

The following instructions are for the use and preparation of an all-inclusive trust deed (AITD) note, **first tuesday** Form 421. Form 421 consists of provisions from a regular interest-included installment note, modified by adding provisions (sections 3.1 and 3.2) to disclose that the amount of the all-inclusive note includes the balance remaining on one or more underlying loans, the payment of which the carryback seller remains responsible. [See Form 421 accompanying this chapter]

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the dollar amount of the all-inclusive note, the date the note is prepared and the name of the city where the note is prepared. This information is used when referring to this note and must conform with the dollar amount, date and location entered on the trust deed used to secure this note to real estate.

1. *Promise to pay*: **States** the payor's promise to pay the debt on the terms and provisions contained in the note.

   1.1 *Payee*: **Enter** the name of the person who is to receive the payments, typically the carryback seller, his assignee or a §1031 buyer's trustee. The all-inclusive trust deed identifies the payee as the *beneficiary*.

   1.2 *Place of payment*: **Enter** the city where payments are to be delivered to the payee.

   1.3 *Debt amount*: **Enter** the amount of the principal to be paid on the note.

Editor's note — The principal amount is the same as in the document identification section above, unless escrow is instructed to enter a different debt amount on closing due to adjustments in price or down payment.

   1.4 *Interest accrual date*: **Enter** the date interest begins to accrue, usually the date escrow closes.

Editor's note — The closing date of escrow is usually uncertain until it occurs. Thus, the space for commencement of accrual is left blank when the note is prepared. Escrow is instructed to enter the closing date when it is known.

   1.5 *Interest rate*: **Enter** the interest rate negotiated and agreed to in the purchase agreement.

*Editor's note — The all-inclusive note is not formulated for variable interest rates. Use **first tuesday** Form 433 and add all-inclusive provisions noted in instructions for its use.*

2. *Installment payments*: **Enter** the dollar amount to be paid as scheduled installments. If scheduled installments change during the life of the note, also **enter** an asterisk here and at section 5 and, following the asterisk at section 5, **enter** the dollar amount of each change and the date the change will begin.

   2.1 *Payment schedule*: **Enter** the day of the month each payment is due to be received by the holder of the note.

ALL-INCLUSIVE PROMISSORY NOTE SECURED BY DEED OF TRUST

NOTE: RECOMMENDED FOR USE WITH **first tuesday** FORMS 442 AND 443.

$_______________, dated _____________, 20______, at _____________________________________, California.

1. In installments as herein stated, for value received, I, jointly and severally, promise to pay to

1.1 ____, as the Payee, or order,

1.2 at ____,

1.3 the sum of ____ DOLLARS,

1.4 with interest from __________________, 20______, on unpaid principal

1.5 at the rate of _________% per annum.

2. Principal and interest payable in installments of ____________________________________ DOLLARS, or more,

2.1 on the _____________ day of each __________________ month,

2.2 beginning on the _____________ day of ____________________, 20________,

2.3 and continuing until _____________, 20______, when the principal is due and payable.

2.4 Principal and interest payable in lawful money of the United States.

2.5 Each payment shall be credited first on interest then due and the remainder on principal.

3. The principal amount of this Note includes:

3.1 The present unpaid balance of $_______________, on a debt evidenced by a Note and secured by an existing Trust Deed held by ____, in the original amount of $_______________, which debt remains the obligation of Payee.

3.2 The present unpaid balance of $_______________, on a debt evidenced by a Note and secured by an existing Trust Deed held by ____, in the original amount of $_______________, which debt remains the obligation of Payee.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

5. ____

____

____

____

____

____

____

____

____

6. In any action to enforce this Note, the prevailing party shall receive attorney fees.

7. This Note is secured by a DEED OF TRUST.

Payor's Name: ________________________________	Payor's Name: ________________________________
Signature: ____________________________________	Signature: ____________________________________
Payor's Name: ________________________________	Payor's Name: ________________________________
Signature: ____________________________________	Signature: ____________________________________

Enter the frequency of payments by stating the number of months separating payments, e.g., “consecutive” when installments are due every month, “other” when bi-monthly, “third” when payable quarterly, “sixth” when payable semi-annually and “twelfth” when payable annually.

Editor’s note — A payment is delinquent after the due date, unless a grace period, by statute or by agreement, extends the date on which payments may be delivered to the holder before becoming delinquent.

2.2 *First payment date*: **Enter** the due date (day and month) for the first payment, typically agreed to as 30 days after the commencement of interest, or the first day of the month first following 30 days after the close of escrow in which case escrow credits the seller with interest which will accrue through the end of the month of closing.

2.3 *Date of final installment*: **Enter** the words “until paid” if the carryback is to be fully amortized by constant monthly payments, or the date when any remaining balance is due. If the due date is on an anniversary of the close of escrow, such as five years after close of escrow, **instruct** escrow to enter this date on closing.

2.4 *Form of payment*: **States** the installment payments and final/balloon payment are to be paid in United States dollars.

2.5 *Interest accrual*: **States** the installment payments are to be credited first toward interest accrued and then to principal.

3. *All-inclusive provisions*: **Provides** that the dollar amount of the existing debt encumbering the property is included in the amount of principal of the all-inclusive note.

3.1 *First underlying encumbrance*: **Enter** the dollar amount of the principal balance remaining on the first trust deed as of the close of escrow, **enter** the name of the current lender (beneficiary), and **enter** the original dollar amount of the first trust deed. A beneficiary statement should be ordered to disclose this information.

3.2 *Second underlying encumbrance*: **Enter** the dollar amount of the principal balance remaining on the second trust deed as of the close of escrow, **enter** the name of the current lender, and **enter** the original dollar amount of the second trust deed note. A beneficiary statement is the primary source for disclosure of this information.

4. *Default provision*: **Provides** for the note holder to declare the entire amount of the note due and immediately payable on failure of the payee to timely pay an installment. However, a properly executed call is unenforceable until the reinstatement period during a foreclosure has expired, except in the case of an incurable breach under trust deed provisions for alienation and waste.

5. *Special provisions*: **Enter** any special provisions to be included in the note, such as a late charge or balloon payment notice.

6. *Attorney fees*: **Provides** for the prevailing party in any litigation on the note to recover his attorney fees incurred in the litigation.

7. *Identification of security*: **States** the note is secured by a trust deed. The link up with the property which is the security is made through the trust deed which references this note by amount, date prepared and city of preparation, naming the original payor and payee of this note as the trustor and beneficiary under the trust deed.

ALL-INCLUSIVE TRUST DEED ADDENDUM

Equity Payoff

NOTE: Recommended for use with **ft** Forms 421and 450.

DATE:_____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated __________________, at ________________________________, California, between ____, as the Trustor, and ____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:

1.1 A trust deed recorded on ______________________________, as Instrument No. ___________________, in ____ County Records, California, executed by ____, as the Trustor, in which ____ is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______% interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on ________________________________, as Instrument No. _________________, in ____ County Records, California, executed by ____, as the Trustor, in which ____ is the Beneficiary, securing a note in the original amount of $_______________ with an unpaid balance of $_______________, payable in installments of $_______________ monthly, including _______% interest, ☐ ARM, all due _____________, 20______.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth ($\frac{1}{12}$) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_______________ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for Beneficiary.]*
Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the Underlying Obligation, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby less the total balance due on the Underlying Obligations, plus any advances or other disbursements which Beneficiary may be permitted to include.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount then unpaid shall be reduced by the then unpaid balance of the Underlying Obligations.

Preparation of the all-inclusive trust deed addenda

The two variations of the all-inclusive trust deed (AITD), the **full payoff** and the **equity payoff**, are differentiated by the amount of the payoff demand the carryback seller can request for satisfaction of the all-inclusive note and reconveyance of the AITD. [See Forms 442 and 443 accompanying this chapter]

Each variety is documented by an addendum which is attached to a standard form trust deed, thus converting the trust deed into an AITD.

The two types of AITD addenda contain differing formulas for the amount of the payoff and foreclosure sale demands.

Other than their payoff formulas (sections 7 and 8), the two AITD addenda contain the same information and provisions.

The following instructions are for the use and preparation of AITD addenda to be attached to a regular trust deed. [See Form 450 in Chapter 14]

When attaching an AITD addendum to a trust deed, state on the face of the trust deed, "The attached AITD addendum is a part of this Deed of Trust."

Each instruction corresponds to the provision in the form bearing the same number.

Editor's note — ***Check*** *and* ***enter*** *items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the all-inclusive trust deed (AITD) addendum is prepared. This date is used when referring to this document.

Facts: referenced trust deed:

Enter the same date and name of the city as entered on the trust deed to which this addendum is attached. The same date is also entered on the all-inclusive note.

Enter as the trustor the name of each individual or entity signing the trust deed, typically all persons signing the note, except co-signers.

Enter as the beneficiary the payee named in the note, be it the seller of the real estate, his assignee or the §1031 trustee.

1. *Existing financing*: **Provides** information identifying the existing encumbrances on the property, the principal amounts of which are included in the all-inclusive trust deed (AITD) note amount.

    1.1 *First trust deed*: **Enter** the date the underlying first trust deed was recorded, its instrument number and the county of record.

Enter the name of the borrower (trustor) and the lender (beneficiary) named in the underlying first trust deed.

ALL-INCLUSIVE TRUST DEED ADDENDUM

Full Payoff

NOTE: Recommended for use with **ft** Forms 421 and 450.

DATE:_____________, 20______, at____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated _____________, 20______, at ___________________________, California,
between ____, as the Trustor,
and ____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:

1.1 A trust deed recorded on ______________________________, as Instrument No. ___________________,
in ____ County Records, California,
executed by ____, as the Trustor,
in which ____ is the Beneficiary,
securing a note in the original amount of $_______________ with an unpaid balance of $_______________,
payable in installments of $_______________ monthly, including _______ % interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on ________________________________, as Instrument No. _________________,
in ____ County Records, California,
executed by ____, as the Trustor,
in which ____ is the Beneficiary,
securing a note in the original amount of $_______________ with an unpaid balance of $_______________,
payable in installments of $_______________ monthly, including _______% interest, ☐ ARM,
all due _____________, 20______.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_______________ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for Beneficiary.]*
Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the Underlying Obligations, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby, plus any advances or other disbursements which Beneficiary may be permitted to include, on which bid Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount of the payoff shall be the then unpaid principal and interest, and on receipt of payoff funds, Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

Enter the original amount of the underlying first trust deed, the remaining principal balance, the dollar amount of the monthly payment, the interest rate and any due date.

Check the appropriate boxes to indicate a variable interest rate or impounds are provided for in the first trust deed note.

1.2 *Second trust deed*: **Enter** the date the underlying second trust deed was recorded, its instrument number and the county of record.

Enter the name of the borrower (trustor) and the lender (beneficiary) named in the underlying second trust deed.

Enter the original amount of the underlying second trust deed, the remaining principal balance, the dollar amount of the monthly payment, the interest rate and any due date.

Check the appropriate boxes to indicate a variable interest rate or impounds are provided for in the second trust deed note.

1.3 *Payment of wrapped loans*: **States** the seller, as the beneficiary of the trust deed, remains responsible for payment of the underlying wrapped loans referenced in sections 1.1 and 1.2, subject to the terms of the addendum.

2. *Impounds*: **Check** if monthly impounds will be paid to the seller by the buyer for property taxes and casualty insurance.

Editor's note — If a wrapped loan is impounded, then the AITD should also be impounded.

3. *Contract collection*: **Check** if the seller has agreed with the buyer to place the note on collection with a third party.

Editor's note — The seller should not agree to a contract collection provision if he intends to receive the full tax benefits of an installment sale. The collection agent under a mutual agreement with the buyer is deemed to be the agent of the buyer, thus relieving the seller of responsibility for payments on the underlying loan.

4. *Seller's default/buyer's remedies*: **States**, should the seller default on the underlying wrapped encumbrances, the buyer may cure the defaults and make payments directly on the delinquent underlying encumbrance. Payments advanced by the buyer either apply against the agreed-to AITD installments or, alternatively, are refunded by the seller on demand. One is an out-of-pocket setoff, the other is a refund.

5. *Buyer's default/seller's remedies*: **States**, should the buyer fail to make payments on the AITD note, the seller is no longer required to make payments on the underlying wrapped encumbrances unless the AITD is reinstated.

Editor's note — Any late charges or foreclosure costs incurred by the seller on the underlying wrapped encumbrances due to the buyer's default in AITD payments are "passed through" to the defaulting buyer as future advances due the seller if the AITD note does not itself contain a late charge provision.

6. *Prepayment penalty pass-through*: **States** a payoff of an underlying encumbrance caused by the buyer or made at the request of the buyer which incurs a prepayment penalty places responsibility for payment of the penalty on the buyer.

7. **Foreclosure bid, equity payoff AITD (Form 442): States** the seller's demand on foreclosure of the all-inclusive trust deed (AITD) will be the amount of his equity in the AITD. The AITD equity is the difference between the balance remaining on the all-inclusive note and the balance(s) remaining on the underlying encumbrance(s). The buyer at the foreclosure sale will take the trustee's deed subject to the underlying encumbrance(s).

8. **Foreclosure bid, full payoff AITD (Form 443): States**, on foreclosure under the AITD, the seller will demand and bid the entire balance of the all-inclusive note. Concurrent with the foreclosure sale, the seller will satisfy and obtain a reconveyance of the underlying encumbrance, unless the seller is the successful bidder and credits himself with the underlying loan amount he assumes.

9. **Payoff demand, equity payoff AITD (Form 442): States** the payoff demand for reconveyance of the all-inclusive trust deed (AITD) is the difference in the amounts remaining due on the all-inclusive note and the underlying wrapped encumbrances.

10. **Payoff demand, full payoff AITD (Form 443): States** the payoff demand for reconveyance of the all-inclusive trust deed (AITD) is the entire principal amount remaining on the all-inclusive note, plus accrued interest, advances and costs. On payoff, the AITD holder will satisfy and obtain reconveyance of the underlying encumbrances.

Chapter 35 Alternative security devices for sellers

This chapter comments on the use of alternative financing arrangements in lieu of a trust deed to mask a sale of real estate

Creative financing vs. creative chaos

The variables for repayment of any debt make up the "creative" aspect of financing, such as the amount of the debt, the interest rate, payment schedule and due date.

Two sets of forms are used in a sale of real estate to document the terms of any carryback financing which will be junior to any existing trust deed liens:

- a note and trust deed, to evidence and secure the balance of the seller's **equity remaining** to be paid after the down payment; or
- an all-inclusive note and trust deed (AITD), to evidence and secure the balance of the **price remaining** to be paid after the down payment.

All other forms used for documenting the terms of carryback financing offer not creative financing, but creative **chaos**, both legal and financial.

Seller financing consists solely of arranging the financing of real estate through the seller's extension of credit on the sales price — an installment sale. Arranging financing does not include the creation of **alternative documentation** to the note and trust deed, sometimes called *masked security devices*.

Creating new forms, by using forms which serve a different purpose than a trust deed (such as a lease-option) or using forms which have outlived their once useful purpose (such as the very obsolete land sales contract), is the primary cause of creative chaos and mistaken expectations.

Documents developed for otherwise legitimate business purposes are occasionally substituted for notes and trust deeds to set up a *smoke screen* in an attempt to avoid due-on enforcement, reassessment for property tax purposes, income tax reporting of profits and the buyer's right of reinstatement or redemption on a default. The purpose is to corrupt the system set up to track conveyancing and, too often, the intended result is actually attained without penalty.

Alternative documentation for a carryback sale includes such instruments as:

- land sales contracts, sometimes called *contracts for deed*;
- long-term escrows with interim occupancy;
- unexecuted or open-ended purchase agreements with interim occupancy, sometimes called *lease-purchase agreements*;
- lease-option sales contracts; and

- reverse trust deeds coupled with one of the above.

Masking the obvious sale

During periods of rising interest rates and decreasing sales, when the frequency of lender due-on enforcement also tends to rise, these alternative financing techniques share a common strategy of creating trappings that **mask the existence** of a sale in order to avoid due-on enforcement. In the masking process, reassessments for an increase in property taxes do not automatically occur.

However, trust deed lenders with due-on clauses are allowed to call or recast a loan on the transfer of any property interest, including a sale, a transfer of any possessory interest, a further encumbrance or a foreclosure of the property, whether recorded or not. [12 Code of Federal Regulations §591.2(b); see Chapter 18]

Notable exceptions for the marketplace allow leases of three years or less on any property (without a purchase option), and further encumbrance of owner-occupied, single family residences (SFRs) to escape due-on enforcement.

Since attempts to hide sales from the lender and county assessor usually involve the use of alternative security devices, inherent financial disadvantages exist from the outset of the transaction.

Additionally, by changing the intended use of legitimate documents, the legal rights of the parties to the transaction become different from the rights permitted by the use for which the document was originally drafted, called recharacterization.

With most alternative security arrangements, the new owner/buyer fails to become the owner of record and often fails to exercise the full benefits of ownership, such as interest/depreciation deductions, the right to further encumber the property, property tax exemptions, etc.

Hiding the purchase from the lender generally includes hiding it from everyone, including the Internal Revenue Service (IRS), Franchise Tax Board (FTB), assessors and creditors.

Other disadvantages exist for owner/buyers who use alternative carryback devices in lieu of a note and trust deed, such as the **lack of recording** the documents and the loss of the benefit extended to recorded documents, as well as the lack of title insurance.

If a carryback transaction is to go **unrecorded, unescrowed and uninsured**, at the very least the proper documents should be used — a grant deed, trust deed and note — to avoid compounding the failure to record and obtain a title insurance policy by using chaotic documentation.

Contract for deed: the land sales contract

The **land sales contract** was widely used from the late 1960s to the late 1970s as the preferred method for avoiding due-on enforcement by lenders.

The financing arrangement is deceptively simple. A buyer and seller enter into a contract for the sale of property. The buyer takes possession of the property and makes payments according to the terms of the contract. The transaction lacks a formal escrow, title insurance, the numerous disclosures of property conditions and statutorily mandated seller financing disclosures. [See Figure 1]

Title does not formally pass by grant deed until the buyer pays the seller in full.

Figure 1

FINANCIAL DISCLOSURE STATEMENT
For Entering Into a Land Sales Contract

NOTE: This disclosure statement is required to be acknowledged by both the Seller (Vendor) and the Buyer (Vendee) when the Seller extends credit by the Buyer executing a debt obligation to pay for part of the sales price of property containing four-or-less residential units on a Land Sales Contract. [Calif. Civil Code §2956]

This disclosure is to be prepared and presented to all parties by the Broker of the party who offers or counteroffers to buy, sell or exchange on a Lease-Option sales agreement.

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

1. FACTS:

This is an addendum to the following agreement:

☐ Offer for Land Sales Contract [See **ft** Form 167]

☐ Land Sales Contract [See **ft** Form 168]

1.1 dated _____________, 20______

1.2 entered into by ____, as the Vendor, and

1.3 ____, as the Vendee,

1.4 regarding property referred to as ____.

DISCLOSURES:

2. GENERAL INFORMATION CONCERNING TERMS OF PAYMENT:

2.1 The balance of the purchase price due Vendor is $_______________, payable in constant monthly installments of $_______________, to include ______ % per annum interest, all due and payable with a final/balloon payment on _____________, 20______, in the approximate amount of $_______________.

2.2 The Land Sales Contract provides for a final/balloon payment. Thus, the debt is not fully amortized. On the final/balloon payment date, the availability of refinancing, modification or extension of the final/balloon payment cannot be assured.

2.3 Vendor remains responsible to remit payments to Payees under senior encumbrances on receipt of installments paid by Vendee.

Notice: *The Vendor and Vendee may wish to use a collection agent for the purpose of accepting the Vendee's payments and disbursing payment to underlying lenders and the Land Sales Contract.*

2.4 This Land Sales Contract is subject to the following provision: "This Land Sales Contract is subject to section 2966 of the Civil Code, which provides that the holder of this instrument shall give written notice to the Vendee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due." [See **ft** Form 419]

2.5 The Land Sales Contract wraps an existing trust deed, and any costs incurred by Vendor for prepayment penalties, late charges, due-on-sale or further encumbrance acceleration and future advances will be passed on to Vendee for payment. [See **ft** Form 168]

3. SPECIAL PROVISIONS AND DISCLOSURES:

3.1 ☐ Vendor will be designated as loss payee under Vendee's hazard and fire insurance, or
☐ Vendee will be designated as loss payee under Vendor's hazard and fire insurance.

3.2 Requests for Notice of Default and Notice of Delinquency under California Civil Code sections 2924b and 2924e ☐ will, or ☐ will not, be recorded for notice to Vendee on encumbrances senior to the Land Sales Contract. [See **ft** Form 167 §14]

3.3 The land sales contract transaction ☐ will, or ☐ will not, be escrowed for the delivery of the signed Land Sales Contract to Vendor and possession to Vendee.

3.4 The Land Sales Contract ☐ will, or ☐ will not, be recorded. The lack of a recording may impair Vendee's interest in the property if liens attach to Vendor's interest in the property.

3.5 Vendee's policy of title insurance ☐ will, or ☐ will not, be obtained from a title insurance company.

3.6 No tax reporting service will be obtained. If an impound rider is agreed to, Vendee will confirm the real estate taxes are paid by Vendor. If no impound rider is agreed to, Vendor will confirm the real estate taxes are paid by Vendee.

3.7 Vendee shall receive no proceeds or cash back on execution of the Land Sales Contract.

3.8 Vendor is aware his sole source of recovery on Vendee's default is limited to the credit bid or net proceeds

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from Vendor's foreclosure under the Land Sales Contract. [Calif. Code of Civil Procedure §580b]

4. ENCUMBRANCES SENIOR TO THE LAND SALES CONTRACT:

4.1 The conditions of encumbrances with priority over the Land Sales Contract include:

	First Loan	Second Loan
Original balance:	$______________	$______________
Current balance:	$______________	$______________
Interest rate:	_____% ☐ ARM	_____% ☐ ARM
	Type ___________	Type ___________
Monthly payments:	$______________	$______________
Due date:	_________, 20____	_________, 20____
Balloon payment:	$______________	$______________
Current defaults:	$______________	$______________

4.2 If any of the senior encumbrances contain a due date for a final/balloon payment, it may be difficult or impossible to refinance, modify or extend the balloon payment in the mortgage marketplace.

5. VENDEE CREDIT INFORMATION:

5.1 ☐ Vendee to hand Vendor a completed credit application on acceptance [See **ft** Form 302]; and

5.2 Vendor may terminate this agreement within ______ days of Vendor's receipt of Vendee's credit application by delivering to Vendee or Vendee's Broker a written Notice of Cancellation based on disapproval of Vendee's credit. [**ft** Form 183]

6. BROKER DISCLOSURES:

6.1 Credit data is supplied by Vendee. Broker knows of no falsity or omission concerning Vendee's credit information.

6.2 This statement and its contents, being statutorily required disclosures, do not limit Broker's duties to disclose other facts material to Vendee or Vendor.

6.3 This statement is an addendum to the agreement referenced at §1 and creates no rights to rescind the Land Sales Contract.

6.4 This statement was prepared by ____
____

7. OTHER: ____
____
____
____
____
____

Buyer's Broker: ___________________________	**Seller's Broker:** ___________________________
By: ___________________________	By: ___________________________
I have received and read a copy of this statement.	**I have received and read a copy of this statement.**
Date: _____________, 20______	Date: _____________, 20______
Vendee: ___________________________	Vendor: ___________________________
Vendee: ___________________________	Vendor: ___________________________

FORM 300-1 04-08

One might argue the existing lender of record has no cause to call the loan since the record of ownership of the property does not officially change until the contract is fully performed. However, this argument fails since title is not in issue; ownership and its use is.

On entering into a land sales contract, an *equitable conversion* of ownership occurs since the seller from that moment forward is only entitled to receive money, not a return of the property except by foreclosure. Thus, the buyer becomes the *equitable owner* of the real estate with the **right of redemption** to pay all sums due the seller and get clear title. No right of reinstatement exists with a land sales contract. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

However, as straight forward as the land sales contract may sound, it has proven to be an extremely fragile economic and legal affair.

Although a land sales contract with a power-of-sale provision is accorded the same statutory treatment as a trust deed, courts give unequal treatment to the defaulting buyer under a land sales contract which is devoid of a power-of-sale provision. Most land sales contracts provide no such power of sale and must be **judicially foreclosed** on a default.

A defaulting buyer who has built up a substantial equity under a land sales contract has an unconditional right to complete the purchase by paying the entire remaining balance, a *redemption*. However, the buyer has no **right to reinstate** on a default, unless the contract includes terms for a reinstatement or a trustee's power-of-sale provision (which automatically permits the rights of reinstatement and redemption). [**Petersen** v. **Hartell** (1985) 40 C3d 102]

The trend is to regard the land sales contract without a power-of-sale provision as a mortgage. A mortgage bears no legal difference from a carryback trust deed, except for the lack of a power-of-sale provision and the owner's right to reinstate on a default, all of which accompanies the trustee's power-of-sale foreclosure process. [**Perry** v. **O'Donnell** (9th Cir. 1985) 759 F2d 702]

A basic land sales contract is an agreement to convey title to the buyer when the buyer **fully satisfies** the dollar amount remaining unpaid on the purchase price, sometimes called a *contract for deed*.

Also, to fit within the statutory definition of a land sales contract, the agreement to convey title must not call for the transfer of title until more than one year has passed after the buyer is given possession of the property. [Calif. Civil Code §2985]

The seller under the land sales contract, recharacterized as a *vendor*, retains legal title **as security** for the buyer's promised payment of the balance of the purchase price. The buyer, recharacterized as a *vendee*, receives possession of the property and automatically becomes the **equitable owner** of the property.

Although the unrecorded land sales contract is often used to mask a sale of real estate, the sale is actually completed when the land sales contract is signed by the parties and delivered to the seller in exchange for the transfer of possession of the property to the buyer. A small downpayment to the seller usually accompanies the transaction.

Conveyance of title to the buyer usually occurs years later when a formal sales escrow is opened to complete the seller's performance of the land sales contract, an event no different in legal and financial effect than the **reconveyance of a trust deed lien** from title on payment in full.

Figure 2

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OFFER FOR LAND SALES CONTRACT

NOTE: To be used with Land Sales Contract Form 168 published by **first tuesday.**

DATE: ____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. Received from ____, as the Buyer(s),
- 1.1 the sum of $______________, evidenced by ☐ personal check, or ☐ ______________________,
  payable to ______________________________, for deposit only on acceptance of this offer.
- 1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
- 1.3 situated in the City of ______________________, County of __________________, California,
- 1.4 referred to as ____.
- 1.5 including personal property, ☐ see attached Personal Property Inventory. [See **ft** Form 256]

2. This agreement is comprised of this three-page form and ______ additional pages of addenda/attachments.

TERMS:

3. Buyer to purchase the property for the price of . . . . $______________
- 3.1 The cash down payment on the price on entering into the Land Sales Contract. . . . . . $______________
- 3.2 The balance of the purchase price is the sum of . . . . $______________
  - a. bearing interest from the date of ☐ the Land Sales Contract, or ☐ ____________, 20______, on unpaid principal at the annual rate of ______%,
  - b. payable in installments of $____________, or more, on the ____________ day of each consecutive month beginning on the ____________ day of ____________, 20______, and continuing until ____________, 20______, when the principal is due and payable.

CONDITIONS:

4. This Offer shall be deemed revoked unless accepted in writing ☐ on presentation, or within ______ days after date, and acceptance is personally delivered to Offeror or Offeror's Broker within the period.
- 4.1 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

5. Buyer(s) and Seller(s) hereby approve the Land Sales Contract Form 168 published by **first tuesday** and agree to sign an original copy, held by Broker, within ______ days of receipt of the prepared Land Sales Contract. Broker will deliver the signed Land Sales Contract to Seller and keys/access codes to Buyer, along with possession, on ____________, 20______. [See **ft** Form 168]

6. Title is subject to current property taxes, covenants, conditions, restrictions, reservations and easements of record. Title is encumbered with the following debt obligations payable by Seller under the Land Sales Contract:
- 6.1 Trust deed note with an unpaid balance of $______________, principal and interest payments being $______________ monthly ____________, including interest at ______%, ☐ adjustable, monthly impounds being an additional $______________. The note and trust deed contain provisions for ☐ due-on sale, ☐ prepayment penalty of ______________________________.
- 6.2 Trust deed note with an unpaid balance of $______________, principal and interest payments being ______________ monthly, including interest at ______%, due ____________, 20______.
- 6.3 Bond or assessment liens of record in the amount of $______________.

7. If an **Homeowners' Association** (HOA) is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed copies of the HOA's Articles, Bylaws, CC&Rs, collection and lien enforcement policy, operating rules, operating budget, CPA's financial review, insurance policy summary and any age restriction statement.
- 7.1 Current monthly assessment is $______________. No association claims for defects or changes in regular or special assessments are pending or anticipated.
- 7.2 Seller is not in violation of CC&Rs, except ______________________________________.
- 7.3 Seller to pay association document and transfer fees.
- 7.4 Buyer to approve the HOA's statement of condition of assessments and confirm representations in subsection "a." above as a condition for closing escrow.
- 7.5 Within ten days of Buyer's post-acceptance receipt of the HOA's documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [See **ft** Form 183]

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8. Seller's Criminal Activity and Security Disclosure Statement [See **ft** Form 321]
- 8.1 ☐ is attached, or
- 8.2 ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Criminal Activity and Security Disclosure Statement.

9. ☐ Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]
- 9.1 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness. [See **ft** Form 183]

10. ☐ Parties to sign attached Land Sales Contract Financial Disclosure Statement. [See **ft** Form 309]

11. Seller to furnish prior to transfer of possession:
- 11.1 ☐ a structural pest control report and clearance.
- 11.2 ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.
- 11.3 ☐ a one-year home warranty policy:
  Insurer ____
  Coverage ____.
- 11.4 ☐ a certificate of occupancy, or other clearance or retrofitting, as required by local ordinance for the transfer of possession or title.

12. Seller's Natural Hazard Disclosure Statement [**ft** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of receipt, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the statement and unknown to buyer prior to acceptance. [See **ft** Forms 182 and 183]

13. Seller's Condition of Property Disclosure — Transfer Disclosure Statement (TDS) [See **ft** Form 304]:
- 13.1 ☐ is attached; or
- 13.2 ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may deliver to Seller or Seller's Broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance [See **ft** Form 269]. Seller to repair, replace or correct noticed defects prior to closing.
- 13.3 On Seller's failure to repair, replace or correct noticed defects, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [See **ft** Form 183]

14. Buyer acknowledges receipt of a booklet and related Seller disclosures containing: ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978, one-to-four units) [See **ft** Form 313], and ☐ *The Homeowner's Guide to* Earthquake Safety (on all pre-1960, one-to-four units). [See **ft** Form 315]

15. ☐ Seller to provide a Request for Notice of Default and Notice of Delinquency to underlying lenders. [See **ft** Form 412]

16. Fixtures and fittings attached to the property include but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, TV antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

17. This property is located in a(n): ☐ Industrial use area, ☐ Military ordnance area, ☐ Airport influence area, ☐ Rent Control Area, ☐ ____

18. Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

19. If this property or an adjoining property contains a solar collector authorized by the Solar Shade Control Act (California Public Resources Code §25980 et seq.) and notice of its existence has been sent or received by Seller, then on acceptance, Seller to hand Buyer copies of the notices sent or received by Seller or provided to Seller by prior Owners of the property for Buyer's review. Buyer may, within ten days after receipt, terminate this agreement based on a reasonable disapproval of the conditions disclosed by the solar shade control notices.

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20. Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice. [See **ft** Forms 172-2 or 173-2]

21. Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to $______________, or ☐ the deposit receipted in Section 1.

22. Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP Code in which he or she resides.

23. Buyer to obtain hazard and personal liability insurance to cover Buyer's interest in the property.

24. Seller to pay a brokerage fee of $______________ on entering into the Land Sales Contract and $______________ on payoff of the balance due on the Land Sales Contract. Seller's Broker and Buyer's Broker, respectively, to share the brokerage fee ____________:____________.

25. ☐ See attached Agency Law Disclosure. [See **ft** Form 305]

26. ☐ See attached Notice of Supplemental Property Tax Bill. [See **ft** Form 317]

27. ____

Buyer's	Seller's
Buyer's/ Selling Broker: ______________	Seller's/ Listing Broker: ______________
Broker's DRE Identification #: ______________	Broker's DRE Identification #: ______________
Selling Agent: ______________	Listing Agent: ______________
Agent's DRE Identification #: ______________	Agent's DRE Identification #: ______________
Signature: ______________	Signature: ______________
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: ______________	Address: ______________
Phone: ______________	Phone: ______________
Fax: ______________	Fax: ______________
Email: ______________	Email: ______________
I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See Signature Page Addendum. [**ft** Form 251]	☐ See Signature Page Addendum. [**ft** Form 251]
Date: ____________, 20______	Date: ____________, 20______
Buyer: ______________	Seller: ______________
Signature: ______________	Signature: ______________
Buyer: ______________	Seller: ______________
Signature: ______________	Signature: ______________

FORM 167 01-09

The **conveyance escrow** is not a "sales escrow" at all. It is merely the means used to pay off and release the seller's security interest in the property under the land sales contract. The seller had retained title to the property not as owner, but as the holder of security for the remaining unpaid balance on the credit sale. But what escrow records and the assessor sees is a sale, not the mortgage-burning party it is.

The contentious contract

The buyer and seller should determine and analyze the risks and benefits accompanying their use of an unescrowed, unrecorded and uninsured **land sales contract** before they either:

- sign and deliver an offer to purchase on a land sales contract [See Figure 2]; or
- sign and deliver the land sales contract and transfer downpayment funds and possession. [See Figure 3]

Typically, when a land sales contract is used, the formal aspects of an escrowed sale of real estate are imprudently deferred until a "sales escrow" is opened to handle the buyer's payoff and the seller's transfer of record title to close out the land sales contract.

The later sales escrow, used to satisfy the land sales contract by final payoff, fails to reflect the fact that the actual sale occurred years earlier when the buyer and seller entered into the land sales contract.

The sales escrow, opened to close out the land sales contract transaction, is for the purpose of either:

- a full conveyance and refinancing of the property with a new lender who provides funding for the payoff of the debt owed to the seller on the land sales contract; or
- a seller "rollover" of the remaining contract debt into a note and trust deed, executed by the buyer and received by the seller on a transfer of the title to the buyer.

All costs of a conventional closing incurred in a formal sales escrow, also called *transactional costs*, are avoided at the time of entering into a land sales contract. A seller and a buyer choosing to use a land sales contract rarely if ever escrow the land sales contract transaction, obtain title insurance or local government occupancy or retrofit certificates.

The closing costs are actually deferred until a sales escrow is opened to complete performance of the land sales contract and convey title to the buyer.

Closing costs on a sale include escrow fees, recording costs, title insurance premiums, a beneficiary statement and assumption or loan fees. Reassessment, supplemental tax bills and income taxes are soon to follow these fees.

Often the payment of brokerage fees is in large part deferred as a fractional ownership in, or a lien on, the land sales contract until the seller is paid in full through the sales escrow.

Due-on-sale and reassessment

Consistent with their rationale for not recording a land sales contract, a buyer and seller do not request a **beneficiary statement** from the lender or a **waiver** of the lender's right to call or recast the loan on transfer of equitable ownership.

Thus, sellers and buyers often mistakenly believe an unrecorded sale of real estate (such as a sale on a land sales contract), which is not brought to the attention of the lender or the county assessor, does not trigger the *due-on clause* or *reassessment* as a sale and change of ownership.

On the contrary, entering into a land sales contract triggers both the **due-on clause** in an existing trust deed as a transfer of an interest and **reassessment** as a change of ownership, even if the land sales contract document is not recorded.

Whenever the holder of a trust deed containing a due-on clause discovers the secured property has been sold on a land sales contract, the lender can enforce the due-on clause. Likewise, the county assessor can retroactively reassess on their discovery of the sale.

Contract escrows for delayed recording

Escrow companies have contributed to the creative chaos scene in the form of the **contract escrow**.

The contract escrow actually involves two escrows.

On the close of the sales escrow, the cash down payment is disbursed to a seller. However, all documents normally recorded, such as a grant deed and a trust deed, are placed in a second "holding" escrow. Nothing is recorded, but the proper documentation has been completed.

The sale of property has been closed for purposes of reassessment, due-on-sale and income tax.

The second contract escrow holds the documents until a written request from the buyer or the seller is received by escrow instructing them to record the grant deed and trust deed.

Since both the seller and the buyer have an insurable interest in the property, two separate policies of **fire and hazard insurance** are frequently obtained — one for the seller and another for the buyer. Alternatively, an agreement is entered into by the buyer and seller giving the buyer an interest in the proceeds of the insurance policy.

The carryback note is often placed on contract collection with the same escrow company.

Unexecuted purchase agreements, extended escrows

Similar in approach to the land sales contract is the transfer of possession to the buyer under an **unexecuted purchase agreement**, as a sales escrow will not be closed for an extended period of time.

Here, a **marketing instrument** is used, such as a regular purchase agreement form. The purchase agreement is turned into a **security device** characteristic of a land sales contract or lease-option. The purchase agreement contains a provision for transfer of possession and buildup of equity by a credit to the purchase price for a portion of the buyer's payments to the seller, called a *lease-purchase sale*.

For example, a buyer and a seller sign a standard purchase agreement.

An escrow is opened. A grant deed, a carryback note, a trust deed, and the down payment are deposited into escrow within 30 to 60 days. However, the closing and disbursement of funds are delayed until after one to three years of timely performance by the buyer. During the extended escrow period, payments are

made to the seller which include credit of a portion of the payment toward the down payment (or price) called for in the purchase agreement. Often, the buyer's payments are sent to the same escrow company that received the down payment and documents.

Since the buyer wants to take possession of the property prior to the close of escrow, he enters into an interim occupancy (lease) agreement with the seller. Neither the lease nor the escrow will extend beyond three years, which would avoid triggering any due-on clauses.

Should the seller enter into a lease for more than three years or apply payments toward the purchase price, the transfer of possession will qualify as a sale, triggering reassessment, profit tax reporting, the lender's right to accelerate the loan, etc. [12 CFR §591.2(b)]

For the buyer to protect any increase in the property's value which occurs by the end of the occupancy period, the buyer must:

- timely close the long-term escrow;
- renew or extend the lease; or
- find a buyer who will purchase his position.

The lease-option sale

Buyers and sellers of real estate must understand that a sale structured as a **lease-option** is still a sale. The form used to structure the sale does not change a buyer's and seller's rights and obligations which are provided by mortgage and contract law.

Moreover, a seller seeking to disguise a sale as a lease-option transaction creates risks that are eliminated by more conventional wraparound formats, like the all-inclusive trust deed (AITD).

A sale documented as a lease and option to purchase typically lacks a **power-of-sale** provision which allows for a trustee's foreclosure — the seller's best remedy to recover the property (title and possession) should the buyer default. [See Figure 3]

The lease-option sale usually is not documented through an escrow, nor is there delivery of a grant deed or a note and trust deed. Instead, the buyer will lease the home with an option to purchase it at a **predetermined price**, not a price based on market value at the time of exercising the option.

The down payment, called *option money,* is applied toward the purchase price of the property, should the option be exercised. Similarly, a portion of the monthly payment, called *rent*, will apply as principal paid toward the price on exercise of the option prior to its expiration. Of course, the expiration of the option is the legal equivalent of a due date for payment of the balance of the purchase price. [See Figure 4]

However, when a tenant receives credit toward the purchase price on payment of his option money or rent, the lease-option is *recharacterized* as a land sales contract, mortgage or trust deed for all purposes. Also, a carryback sale structured as a lease-option will typically be devoid of a trust deed power- of-sale provision, prohibiting the seller from rapidly foreclosing by a trustee's sale and wiping out the equity the buyer has paid for and built up in the property.

Figure 3

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

LAND SALES CONTRACT

All-Inclusive with Power of Sale

Items left blank or unchecked are not applicable.

This Agreement, made this _____________ day of ____________, 20______, between

____, as the Vendor,

and ____, as the Vendee,

whose address is ____,
(Number and street) (City) (State) (Zip)

regarding the real property in the City of _______________________________,

County of _______________________________, California, referred to as

1. Subject to the following trust deeds and notes referred to as Underlying Obligations:

1.1 A trust deed recorded ________________, as Instrument No. ____________ in Official Records of ______________________ County, California, executed by ______________________, as Trustor, in which ______________________________ is Beneficiary, securing a note in the original amount of $_____________, with an unpaid balance of $_____________ payable in installments of $____________ monthly including _____ % annual interest, ☐ ARM, ☐ plus payments for impounds _______________________________.

1.2 A trust deed recorded ________________, as Instrument No. ____________ in Official Records of ______________________ County, California executed by ______________________, as Trustor, in which ______________________________ is Beneficiary, securing a note in the original amount of $_____________, with an unpaid balance of $_____________ payable in installments of $_____________ monthly including ______ % annual interest, ☐ ARM, all due _________________.

1.3 ☐ See attached addendum for additional Underlying Obligations.

1.4 Vendor to remain responsible for and to pay all amounts called for in the Underlying Obligations.

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2. Vendee hereby purchases the property for the price of . . . . $______________

2.1 The cash down payment on the price on entering into this agreement is the amount of. . $______________

2.2 The balance of the purchase price is the unpaid sum of. . . . . $______________ bearing interest from date of ☐ agreement, or ☐ ______________________, on unpaid principal at the annual rate of ______ %, payable in installments of $_______________, or more, on the ______ day of each consecutive month beginning on the ______ day of ___________________ and continuing until _____________, 20______, when the principal is due and payable.

3. Vendor retains legal title for the purpose of securing payment of:

a. The balance of the purchase price;

b. Any additional sums and interest hereafter loaned by Vendor to Vendee, or their assignee, evidenced by a promissory note or notes, referencing this agreement as security for payment;

c. The Vendor's charge for a statement regarding the secured obligations requested by or for Vendee; and

d. The performance of each provision contained in this agreement.

VENDEE AGREES:

4. Condition of Property — To keep the property in good condition and repair; not to remove or demolish any building; to complete and restore any building which may be constructed, damaged or destroyed; to comply with all laws affecting the property or requiring any alterations or improvements to be made; not to commit or permit waste; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of the property may be reasonably necessary.

5. Hazard Insurance — Vendee will continuously maintain hazard insurance against loss by fire, hazards included within the term "extended coverage," and any other hazards for which the Vendor requires insurance. The insurance shall be maintained in the amounts and for the periods the Vendor requires. The insurance carrier providing the insurance shall be chosen by Vendee, subject to Vendor's approval, which shall not be unreasonably withheld. All insurance policies shall be acceptable to Vendor, and contain loss payable clauses in form acceptable to Vendor. Vendor shall have the right to hold policies and renewals.

In the event of loss, Vendee shall promptly notify the insurance carrier and Vendor. Vendor may make proof of loss if not made promptly by Vendee. Vendor may place the proceeds in a non-interest bearing account to be used for the cost of reconstruction of the damaged improvements. If Vendee fails to reconstruct, Vendor may receive and apply the loan proceeds to the principal debt hereby secured, without a showing of impairment.

6. Indemnity — To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Vendor; and to pay all costs and expenses.

7. Taxes and Senior Encumbrances — To pay all taxes and assessments affecting the property, including water stock assessments, at least 10 days before delinquency; all encumbrances, charges and liens, with interest, on the property when due, which are not the responsibility of the Vendor and are or appear to be senior to this agreement; and all expenses of this agreement.

8. Acts and Advances to Protect the Security — If Vendee fails to make any payment or to perform any act provided for in this agreement, then Vendor may, at the option of the Vendor and without notice, and without releasing Vendee from any obligation under this agreement:

a. Make or do the same to the extent necessary to protect the security, Vendor being authorized to enter upon the property to do so;

b. Appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Vendor;

c. Pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this agreement.

d. In exercising the power of this provision, Vendor may incur necessary expenses and reasonable attorney fees. Vendee to pay immediately all sums expended by Vendor provided for in this agreement, with interest from date of expenditure at the same rate as the principal debt hereby secured.

VENDOR AND VENDEE AGREE:

9. Assignment of Damages — Vendee assigns to Vendor any award of damages made in connection with:

a. Condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or

b. Injury to the property by any third party.

10. Waiver — By accepting payment of any sum due after its due date, Vendor does not waive Vendor's right to either require prompt payment when due of all other sums or to declare default for failure to pay. Vendor may waive a default of any provision of this agreement, by consent or acquiescence, without waiving any prior or subsequent default.

11. Conveyance of Title — Vendor to convey title free of creditor's liens, subject to existing CC&Rs, to Vendee upon Vendee's payment of all sums due to Vendor under this agreement.

11.1 On conveyance of title from Vendor to Vendee on full performance of this agreement by Vendee, the interest of Vendor and Vendee in the property will be insured by a title insurance policy issued by ______________________ Title Insurance Company, premium to be paid by ☐ Vendor, or ☐ Vendee.

11.2 On Vendee's deposit into escrow of all sums and instruments due to Vendor under this agreement and payment of all customary escrow costs and charges, Vendor to deposit into the escrow all instruments and instructions necessary to convey title and fully perform this agreement.

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12. Due-on-sale — Should Vendee sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, Vendor may, at Vendor's option, declare all sums secured by this agreement immediately due and payable.

13. Assignment of Rents — Vendee hereby assigns and transfers to Vendor all the rights, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this agreement.

Prior to a default on the trust deed by Vendee, Vendee shall collect and retain the rents. On default by Vendee, and without the necessity of Vendor to make demand or take possession of the property in person, by agent or by court appointed receiver, Vendor shall immediately be entitled to possession of all unpaid rents.

14. Acceleration — If payment of any indebtedness or performance of this agreement is in default, then Vendor may at Vendor's option, without notice, declare all sums secured immediately due and payable by:

a. Commencing suit for their recovery by foreclosure of this lien; or

b. Delivering to Trustee a written notice declaring default with demand for sale; a written notice of default and election to sell to be recorded.

15. Power of Sale — On default under any obligation of this agreement and acceleration of all sums due, Vendor may elect to proceed with a power of sale by a trustee substituted under Civil Code §2934a, noticed and held in accordance with California Civil Code §2924 et seq.

15.1 The undersigned Vendee requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Vendee at the address herein set forth.

16. Prepayment Penalty — Any principal paid in addition to regular installments will, if so requested by Vendee, be paid by Vendor to holders of Underlying Obligations for a reduction in the principal. If the holders are entitled to a prepayment penalty, Vendee shall pay the amount to Vendor for payment of the penalty. The prepayment penalty will not reduce the unpaid balance of principal or accrued interest on the debt remaining on this agreement.

17. Cure of Default — If Vendor defaults in his performance on this agreement, including payment of the Underlying Obligations, Vendee may cure the default and credit the payments against the principal and interest due under this agreement, or recover from Vendor, on demand, the amount of the payments including interest thereon at the note rate.

18. Successors, Assigns and Pledgees — This agreement is for the benefit of, and binds all parties, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term "Vendor" shall mean the holder and owner of the agreement, or, if the agreement has been pledged, the pledgee.

19. Vendee's Offset Statement — Within 10 days of Vendee's receipt of a written request by Vendor, Vendee shall execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of the Vendor: the then owner of the secured property; the terms of the secured debt, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured debt is valid and the Vendee received full and valid consideration for it; and that the Vendee understands the debt and this agreement are being assigned.

20. Final Balloon Payment Notice — This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to Vendee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due.

21. Addenda — The following checked addenda are a part of this agreement: ☐ Impounds rider for taxes and insurance; ☐ Owner-occupancy rider; ☐ Contract collection rider; ☐ ______________________________.

22. Attorney Fees — In any action to enforce this agreement, the prevailing party shall receive attorney fees.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Vendor: ___________________________________

Vendor: ___________________________________

☐ See attached Signature Page Addendum. [**ft** Form 251]

Vendee: ___________________________________

Vendee: ___________________________________

STATE OF CALIFORNIA
COUNTY OF_________________________________

On _________________________________ before me,

____
(Name and title of officer)

personally appeared _________________________________

____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature _________________________________
(Signature of notary public)

(This area for official notarial seal)

Except for the absence of legal documentation in the form of a grant deed, note and trust deed, the terms of the lease-option sale have all the **economic characteristics** of a credit sale. There is an agreed-to price, a down payment, monthly rent payments which apply in whole or in part toward principal (the balance being interest) and a due date for the final/balloon payment.

When a buyer in possession of property under an agreement with the seller receives credit toward the purchase price for a portion or all of his payments to the seller, he has built up and established an **equity** in the property. Thus, he has an **ownership interest** which carries with it the *right of redemption* to pay off the seller and get clear title. The buyer's redemption rights can only be terminated by a judicial or nonjudicial foreclosure, or a deed-in-lieu of foreclosure for which the seller (lender) usually needs to pay "key money" to get possession.

A lease-option agreement structured on terms economically consistent with a credit sale (a down payment or credit of payments toward the price) is neither a lease between a tenant and a landlord nor an option to buy. The lease-option sales agreement is a **disguised security device** for credit financing of a sale arranged by a buyer and a carryback seller. [**Oesterreich** v. **Commissioner of Internal Revenue** (9th Cir. 1955) 226 F2d 798]

An actual lease coupled with a separate option to buy is the antithesis of seller financing. A borrower's debt obligations and a lender's foreclosure rights are diametrically opposed to a tenant's leasehold obligations and the eviction rights of a landlord.

Also, all lease-options trigger due-on provisions in trust deeds which encumber property.

Tax aspects

Taxwise, **lease-option sales** are recharacterized by the Internal Revenue Service (IRS), the state Franchise Tax Board (FTB) and the county assessor as carryback financing or land sales contracts.

One reason sellers conceal property sales behind the format of a lease-option is to avoid added tax burdens on a change in ownership. Under an actual option agreement, any option money received by the seller is reported as either **profit or income** when the option is **exercised or expires**, or the property is sold subject to the option.

The seller, disguised as a landlord, will also deduct the amount of the property's annual depreciation to reduce income taxes, until the lease-option is recharacterized by the IRS as a sale.

Buyers are motivated to structure a sale as an unrecorded lease-option to evade property **reassessment** by the county. However, the use of a lease-option to mask a sale has property tax consequences, since the economic characteristics of the transaction constitute a change of ownership, triggering retroactive reassessment when later discovered.

Reverse trust deed

The *reverse trust deed* is often used to provide recorded protection for a buyer's investment in an otherwise unrecorded transfer, such as one involving the two-step contract escrow.

As the name suggests, the economic roles of the buyer and seller in the transaction are reversed.

The buyer documents the amount of the down payment on the property as a loan made to the seller.

Figure 4

LEASE-OPTION
Contract for Deed

NOTE: This form is not for use by an investor acquiring owner-occupied, one-to-four unit residential property in forclosure. [See **ft** Form 156]

DATE: ____________, 20______, at ____, California.
Items left blank or unchecked are not applicable. References to forms include their equivalent.

FACTS:

1. This lease agreement and option to purchase is entered into by Lessor/Optionor and Lessee/Optionee, regarding property situated in the City of ____________________, County of ______________ California, referred to as ____
____
Personal property, ☐ see attached Personal Property Inventory [See **ft** Form 256], ______________________

2. **This agreement is comprised of this three page form and the following checked attachments:**
   ☐ Credit Application [See **ft** Form 302]
   ☐ Residential Earthquake Hazards Report [See **ft** Form 315]
   ☐ Occupant's Operating Expense Sheet [See **ft** Form 562]
   ☐ Addendum — General Use [See **ft** Form 250]
   ☐ Notice of Your Supplemental Property Tax Bill [See **ft** Form 317]
   ☐ Agency Law Disclosure Statement [See **ft** Form 305]
   ☐ Natural Hazard Disclosure Statement [See **ft** Form 314]
   ☐ Financial Disclosure Statement [See **ft** Form 300-2]
   ☐ Brokerage Fee Addendum [See **ft** Form 273]
   ☐ Lead-Based Paint Disclosure [See **ft** Form 313]
   ☐ Condition of Property Disclosure [See **ft** Form 304]

3. **Term of Lease:**
   This lease commences ____________, 20______ and continues until ____________, 20______.
   3.1 The lease terminates on the last day of the term without further notice.
   3.2 If Lessee holds over, Lessee to be liable for rent at the daily rate of $______________.

4. **Rent:** Lessee to pay, in advance, a base monthly rent of $______________ due on the ______ day of each calendar month.
   4.1 Rent to be paid by: ☐ cash, ☐ check, or ☐ cashiers check, at Lessor's address below.
   4.2 Rent to be tendered by: ☐ mail, or ☐ personal delivery.
   4.3 Lessee to pay a late charge of six percent of all rent amounts due in the event rent is not received within ten days of the due date.
   4.4 Lessee to pay $______________ for each rent check returned for insufficient funds and thereafter pay rent by cash or cashier's check.

5. **Additional Rent:** In addition to the base monthly rent, Lessee to pay additional monthly rent equal to the increased costs incurred by Lessor after entering into this lease-option, due to:
   a. ☐ variable/adjustable interest rate on existing loans secured by the property;
   b. ☐ variable/adjustable monthly principal or acceleration of existing loans secured by the property;
   c. ☐ property taxes on the property;
   d. ☐ fire and extended coverage insurance premiums on the property;
   e. ☐ any Homeowners' Association (HOA) assessments;
   f. ☐ any special or improvement assessments on the property; and
   g. ☐ any other expenditures required of Lessor to protect his interest.
   5.1 The additional monthly rent shall be the actual monthly cost increase and 1/12th of any annual cost increase.
   5.2 The additional monthly rent is due on, or beginning with, the monthly rent payment next due following notice to Lessee by Lessor.

6. **Utilities:** Lessee shall pay all costs of public utilities to the property, including any required deposits, installation, or service fees.

7. **Maintenance of Premises:** Lessee agrees to maintain and perform all necessary repairs to the property during the lease term at his sole expense.

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8. **Insurance:** Lessee shall maintain at his sole expense, naming Lessor as an additional insured:
   8.1 ☐ A standard fire insurance policy with extended coverage, vandalism and malicious mischief endorsements, fully covering the replacement cost of all structures on the property during the entire term of the lease; and
   8.2 ☐ Public liability and property damage insurance with a single combined liability limit of at least $300,000 and property damage limits of at least $100,000, insuring against all liability of Lessee arising out of Lessee's use or occupancy of the premises.

9. **Use of the Property:** The property is to be used only as a private residence occupied by Lessee and for no other purpose. Lessee shall comply with all laws regarding the use of the property, and shall not allow any waste or nuisance to occur on the property.

10. **Assignment and Subletting:** Lessee shall not assign this lease, nor sublet or encumber any interest in the property without the prior written consent of Lessor. Any transfer of an interest in the property by Lessee without the prior written consent of Lessor shall, at the option of Lessor, terminate this lease and call for payment of all sums due.

11. **Waiver of Damage:** Lessee releases Lessor from liability for loss or damage to Lessee or any property of Lessee caused by water leakage, breaking pipes, theft, vandalism, or any other cause beyond the reasonable control of Lessor.

12. **Hold Harmless:** Lessee shall indemnify Lessor from liability, damages, and/or expenses arising from the death or injury of any person, including Lessee, or from the damage or destruction of any property, including property owned by Lessee, caused or allegedly caused by some condition of the property, or some act or omission of Lessee or any other person.

OPTION TO PURCHASE:

13. **Option Money:** Optionor acknowledges receipt of option money in the amount of $______________, given in consideration for this option to purchase the property leased.

14. **Option Period:** Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property under the sales terms for a period commencing with the acceptance of this option and expiring on termination of the lease.

15. **Exercise of Option:** Optionee may exercise this option during the option period by:
   15.1 Preparing and signing escrow instructions with ____;
   15.2 Depositing cash in Escrow of $_____________; and
   15.3 Delivering a certified copy of the signed escrow instructions to Optionor within the option period in person or by certified mail.

16. **Delivery of Title:** Within _____ days after exercise, Optionor and Optionee shall place in Escrow all documents and instruments necessary to close.

17. **Sale Terms:** The purchase price is $_____________, payable:
   17.1 ☐ In cash.
   17.2 ☐ Down payment in the amount of $______________.
   17.3 The cash price or down payment to be credited for $______________ of option money paid, and for ______%, or $______________, of each payment of base monthly rent.
   17.4 ☐ Take title subject to, or ☐ Assume, the existing trust deed note with an approximate unpaid balance of $____________, currently payable $______________ monthly, including principal and interest at ______%, ☐ adjustable, monthly impounds being an additional $______________.
   17.5 ☐ Take title subject to, or ☐ Assume, a trust deed note with a principal balance of $______________, currently payable $______________ monthly, including principal and interest at ______%, due ____________.
   17.6 Loan balance differences to be adjusted in: ☐ cash, ☐ §17.8 Note, or ☐ price.
   17.7 ☐ Assume bonds or assessment liens of record in the approximate amount of $______________.
   17.8 A Note for the balance of the purchase price in the amount of $______________, to be executed by Buyer in favor of Seller and secured by a trust deed on the property, payable $______________ monthly, or more, commencing one month after closing, including interest at ______%, due ______________ years after closing.
      a. The Note and Trust Deed shall not contain provisions for due-on clauses, prepayment penalties, or late charges.
      b. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]
      c. ☐ The Note is an All-Inclusive Trust Deed Note.
      d. As additional security, Optionee to execute a security agreement and file a UCC-1 financing statement on any personal property included in the price.

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18. **General Provisions**:
   18.1 Optionee's transfer of any interest in this option terminates the option.
   18.2 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.
   18.3 The prevailing party in any dispute shall be entitled to attorney fees and costs, unless they proceed with litigation without first offering to enter into mediation to resolve the dispute.

19. **Power of Sale:** Should this document be characterized as a security device, on default of rental payments or failure to exercise the option, the Lessor/Optionor may call all sums due and elect to proceed with a power of sale by a trustee substituted under Civil Code §2934(a), noticed and held in accordance with Civil Code §§2924 et seq.

20. **Lessor/Optionor Default:** Should the Lessor/Optionor default on any obligation impairing the Lessee/Optionee's interest under this agreement, Lessee/Optionee may cure the default and demand reimbursement from the Lessor/Optionor of the amount advanced, and if not paid, deduct the amount paid from periodic payments and the purchase price due the Lessor/Optionor.

21. **Expiration of Option:** This option to purchase shall be deemed expired if not exercised during the option period, and if not previously terminated, shall automatically expire/terminate on ____________, 20______.

22. **Brokerage Fee:** Optionor to pay brokerage fees as follows:
   22.1 ______% of the option money on receipt; plus
   22.2 ______% of each month's base rent on receipt; and
   22.3 $______________ on exercise of the option.
   22.4 Optionee's Broker and Optionor's Broker, respectively, to share the brokerage fee ______:______.

23. ____
____
____
____
____
____
____

Lessee/Optionee's Broker: ____________________	Lessor/Optionor's Broker: ____________________
By: ____________________	By: ____________________
Is the agent of: ☐ Lessee/Optionee exclusively, or ☐ both Parties	Is the agent of: ☐ Lessor/Optionor exclusively, or ☐ both Parties
I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: ____________, 20______	Date: ____________, 20______
Lessee/Optionee: ____________________	Lessor/Optionor: ____________________
Signature: ____________________	Signature: ____________________
Lessee/Optionee: ____________________	Lessor/Optionor: ____________________
Signature: ____________________	Signature: ____________________
Address: ____________________	Address: ____________________
____________________	____________________
Phone: ____________________	Phone: ____________________
Fax: ____________________	Fax: ____________________
Email: ____________________	Email: ____________________

FORM 163 02-08

The seller, disguised as an owner borrowing money, signs a note for the amount of the down payment and a trust deed in favor of the buyer. The trust deed appears as the buyer's lien on the very property the buyer is acquiring, hence its name: reverse trust deed.

When escrow closes on the sale, the buyer's reverse trust deed is recorded (naming him as the beneficiary) and the seller receives the net proceeds from the down payment. The buyer takes possession of the property under a lease signed by both the seller (as the landlord) and the buyer (as the tenant).

All other documents regarding the buyer's **actual** purchase of the property — the executed grant deed and any carryback notes or trust deeds — are left unrecorded and placed into a contract or holding escrow. The escrow agent is **instructed** to hold these documents (together with the note and a request for a reconveyance of the reverse trust deed) until the buyer or seller requests they be recorded.

As a result, the record title indicates the seller merely equity-financed his property.

Neither the lender nor the tax assessor are alerted to the transfer as long as the grant deed remains unrecorded and undisclosed. However, both the lender's due-on clause and the assessor's right to reassess have been triggered.

The reverse trust deed takes the place of the Memorandum of Agreement recorded in some contract escrow arrangements.

However, the reverse trust deed does present a degree of financial protection to the buyer. When recorded, it prevents the seller from defeating the buyer's down payment by further encumbering or deeding out the property to a bona fide purchaser (BFP). [**Miller** v. **Cote** (1982) 127 CA3d 888]

Should the seller interfere with the buyer's unrecorded grant deed interest, the buyer can foreclose on the trust deed and wipe out the seller's position.

However, the reverse trust deed is not perfect and has several potentially fatal flaws, both economic and legal.

Economically, price inflation or value appreciation of the property will cyclically outstrip the buyer's ability to protect his equity (due to the historical inflationary monetary policy of the Federal government). Should the buyer ever need to foreclose to recover the amount of his down payment, he will only become the legal owner of the property if he is the successful bidder at a trustee's sale.

Of course, the buyer runs the risk of being overbid by other bidders who appear at the sale. At a minimum, the buyer as the foreclosing beneficiary of the trust deed will get back the amount of his original down payment, plus interest.

Legally, the reverse trust deed is even more disenchanting than lost inflation or appreciation. Even if the buyer could bid high enough at the trustee's sale to acquire title, he still stands to lose the property if the senior lender calls the loan, and if unpaid, forecloses.

If the property is an owner-occupied, one-to-four unit residential property, the owner (meaning the seller, not the buyer) can further encumber and avoid a call under the existing lender's due-on clause only if he **continues to occupy** the property. [12 CFR §591.5(b)(1)(i)]

Thus, the very purpose for using a reverse trust deed (to transfer possession without the risk of the due-on-sale/reassessment) renders it **legally useless**, except to foreclose on the property, since the reverse trust deed does not avoid a call or the recasting of the existing financing or a reassessment when the transaction is discovered by the lender or the county assessor.

Taxwise, a reverse trust deed transaction, unless reported as a sale, exposes the seller to liability for **tax evasion** for deliberately restructuring a sale to appear as a non-taxable event (a loan).

The substance and function of the transaction (the sale of the property) supersedes its recorded form (the trust deed loan).

Also, concealing the sale from the county assessor results in the imposition of stiff property tax penalties by the county tax collector. The seller is also faced with penalties for his failure to report profit to the Internal Revenue Service (IRS) and California's Franchise Tax Board (FTB).

When the grant deed is eventually recorded, its date prepared and notarized will probably alert the assessor to the unrecorded transfer of the property, which occurred a few years earlier. Then the retroactive assessment and tax bills will start arriving — to be paid.

Filing the IRS 1099-S

When a formal sales escrow is not used to handle documents and funds on a sale, the person arranging the sale, generally the broker, is required to report the transaction to the Internal Revenue Service (IRS) on a 1099-S form. [Revenue Regulations §1.6045-4(a)]

The IRS recognizes the sale date to be the earlier of the dates on which:

- title is transferred; or

- the economic benefits and burdens of ownership shift from the seller to the buyer. [Rev. Reg. §1.6045-4(h)(2)(ii)]

Typically, reporting the sale to the IRS with a 1099-S form is incorrectly deferred until the title is conveyed to the buyer through escrow on payoff of the land sales contract, lease-option or other masked security device or off-record handling. Here again, escrow improperly collaborates with the seller, buyer and broker to prevent discovery of the previously masked sale by all persons or agencies, even when escrow closes and reports the closing as the date of the sale.

SECTION E

Lenders

Chapter 36 Conventional financing for a sale

This chapter reviews the procedures used by a transaction agent for obtaining conventional financing to fund the purchase of a principal residence.

Role of the transaction agent (TA)

The ability of a buyer or an owner to obtain financing is an integral component of most real estate transactions, whether the intended use of the loan proceeds is for:

- new property acquisitions;
- tenant improvements (TIs) under a lease;
- construction of buildings; or
- personal-use.

The submission of a *loan application* to a private or institutional lender is the catalyst which sets the machinery of the mortgage industry in motion.

All too often, a buyer needing purchase-assist funding is left to grapple single-handedly with the lender to look out for his own financial interests with no guidance or protective assistance. It is the duty of the **gatekeeper** who brought the buyer into the marketplace, the buyer's selling agent, called by lenders a *transaction agent* (TA), to diligently ensure his buyer negotiates the best financial advantage available to him for the class of loan the buyer seeks.

The TA neither **arranges** nor **makes** a loan. His principal task is to focus on negotiating the real estate transaction, usually between a buyer and seller, but a builder may be involved. However, for the sales transaction to close, and for the TA to get his fee, a loan needs to be arranged with a lender to provide supplemental funding for the buyer's payment of the purchase price. The TA's compensation for negotiating the real estate transaction is only fully earned and payable when he has taken all steps necessary to eliminate the loan funding contingency, the ultimate event allowing escrow to close.

This all-encompassing duty imposed on the TA to diligently serve the buyer's best interests includes policing the:

- loan application submission;
- lender's loan packaging process; and
- funding conditions to vigilantly ensure that all the documents escrow needs to comply with the lender's closing instructions are in order so funding can take place.

Sources of conventional financing

When applying for a **conventional loan**, a buyer has several sources of lenders to choose from, including:

- banks, thrifts and credit unions, called *portfolio lenders*;
- insurance companies and trade association pensions, called *institutional lenders*; and
- mortgage bankers who resell the loan in the secondary loan market, called *warehousing lenders*.

While portfolio and institutional lenders typically service their own loans, they often originate loans for immediate sale as do mortgage bankers, called *warehousing*.

Warehoused loans are sold on the **secondary mortgage market** to investment pools, such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Government National Mortgage Association (Ginnie Mae) and Wall Street bankers.

The business of servicing loans is also bought and sold, causing the loan to appear to be changing hands.

Lenders who originate loans for sale in the **secondary market**, called *Real Estate Settlement Procedures Act* (*RESPA) lenders*, evaluate a buyer's borrowing potential based on the ever changing credit and income requirements and property standards set by the secondary market agency or investment pool seeking to buy newly originated loans.

For the buyer, as with any borrower, the greatest risk of loss of savings and overcommitment of future earnings in a real estate transaction occurs when arranging the loan with the lender's loan representative.

The TA is a paid advisor with a duty owed to the buyer to police all facets of the loan process. This obligation includes eliminating the loan contingency by helping the buyer locate and close on the most advantageous loan terms available in the market. No less could be reasonably expected of an agent.

The TA is the buyer's most reliable and knowledgeable ally in the real estate transaction. This alliance extends beyond the moment the purchase agreement offer is accepted to all critical interactions with the lender who will fund the closing.

The lender is not an agent of the buyer, but his sworn **adversary**. As an outsider to the mortgage lending industry, the unassisted buyer is placed in an inherently submissive position to the lender who will instinctively prey on the buyer's ignorance of the classic loan process to increase its profit. Again, no less could be reasonably expected from a lender.

What must be understood by the TA is that the lender's product – money – is unpriced until closing. This holds true in spite of the good faith estimate of costs (GFE) and interest rate disclosures that are given to the buyer within three business days following the lender's receipt of the loan application. [See **first tuesday** Form 204 (DRE 883)]

The most competent TA has experience policing lenders and is aware of the methods they use to glean the highest rates, most points and high-profit garbage fees from the unprotected buyer. If the lender's tactics are anticipated by the TA, the TA will counsel the buyer so he is on guard against any form of lender deceit. By doing so, the TA prevents lenders from pulling the wool over the buyer's eyes, as history has proven they are prone to do.

Before meeting with a lender rep

A buyer's first step toward obtaining a loan requires him to submit a standardized Uniform Residential Loan Application to a lender as a **prospective borrower**. [See Form 203 (FNMA 1003) accompanying this chapter]

The application itself, designed to be completed by the buyer/borrower with the assistance of the TA and the lender's loan representative, establishes the:

- type of mortgage sought by the buyer/borrower and the terms sought for the loan;
- intended use of the loan funds and the property's information [See **first tuesday** Form 203-3];
- buyer's/borrower's (and co-borrower's) information and employment history;
- monthly income and combined housing (personal) expenses [See **first tuesday** Form 207 (FNMA 1020)];
- assets and liabilities [See **first tuesday** Form 207-1];
- details of the transaction and declarations; and
- acknowledgment and signatures.

However, before submitting the application to the lender, the TA needs to inform the buyer about what to expect during the loan application process. By doing so, the buyer is prepared and well-informed to respond defensively during the loan packaging process which is when the financial stakes are at their highest for both the buyer and lender.

Before submitting the application to the lender, the TA needs to inform his buyer of:

- the expectations held and the role of each servicer or affiliate involved in the loan transaction (the lender's loan representative, the lender funding the loan, any mortgage loan broker involved, private mortgage insurance (PMI) carrier, credit agencies, the appraiser, title insurer and escrow company, etc.);
- what is going to take place during the application process (submission of the application, lender disclosures, payment of lender costs, gathering documents, funding requirements, etc.); and
- what to guard against (issues fabricated by lenders to drive up interest rates and fees beyond their initial estimates on unwary buyers without justification prior to closing).

UNIFORM RESIDENTIAL LOAN APPLICATION
(FNMA 1003)

This application is designed to be completed by the applicant(s) with the Lender's assistance. Applicants should complete this form as "Borrower" or "Co-Borrower," as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when ☐ the income or assets of a person other than the Borrower (including the Borrower's spouse) will be used as a basis for loan qualification or ☐ the income or assets of the Borrower's spouse or other person who has community property rights pursuant to state law will not be used as a basis for loan qualification, but his or her liabilities must be considered because the spouse or other person has community property rights pursuant to applicable law and Borrower resides in a community property state, the security property is located in a community property state, or the Borrower is relying on other property located in a community property state as a basis for repayment of the loan.

If this is an application for joint credit, Borrower and Co-Borrower each agree that we intend to apply for joint credit (sign below):

Borrower's signature Co-Borrower 's signature

I. TYPE OF MORTGAGE AND TERMS OF LOAN

Mortgage Applied for: ☐ VA ☐ FHA	☐ Conventional ☐ USDA/Rural Housing Service	☐ Other (explain):	Agency Case Number	Lender Case Number
Amount $	Interest Rate %	No. of Months	**Amortization Type:** ☐ Fixed Rate ☐ GPM	☐ Other (explain): ☐ ARM (type):

II. PROPERTY INFORMATION AND PURPOSE OF LOAN

Subject Property Address (street, city, state & ZIP)	No. of Units
Legal Description of Subject Property (attach description if necessary)	Year Built

Purpose of Loan ☐ Purchase ☐ Construction ☐ Other (explain): ☐ Refinance ☐ Construction-Permanent

Property will be: ☐ Primary Residence ☐ Secondary Residence ☐ Investment

Complete this line if construction or construction-permanent loan.

Year Lot Acquired	Original Cost	Amount Existing Liens	(a) Present Value of Lot	(b) Cost of Improvements	Total (a + b)
	$	$	$	$	$

Complete this line if this is a refinance loan.

Year Acquired	Original Cost	Amount Existing Liens	Purpose of Refinance	Describe Improvements ☐ made ☐ to be made
	$	$		Cost: $

Title will be held in what Name(s)	Manner in which Title will be held	Estate will be held in: ☐ Fee Simple ☐ Leasehold (show expiration date)
Source of Down Payment, Settlement Charges, and/or Subordinate Financing (explain)		

Borrower | III. BORROWER INFORMATION | Co-Borrower

Borrower				Co-Borrower			
Borrower's Name (include Jr. or Sr. if applicable)				Co-Borrower's Name (include Jr. or Sr. if applicable)			
Social Security Number	Home Phone (incl. area code)	DOB (mm/dd/yyyy)	Yrs. School	Social Security Number	Home Phone (incl. area code)	DOB (mm/dd/yyyy)	Yrs. School
☐ Married ☐ Separated	☐ Unmarried (include single, divorced, widowed)	Dependents (not listed by Co-Borrower) no.	ages	☐ Married ☐ Separated	☐ Unmarried (include single, divorced, widowed)	Dependents (not listed by Borrower) no.	ages
Present Address (street, city, state, ZIP)	☐ Own ☐ Rent ___No. Yrs.			Present Address (street, city, state, ZIP)	☐ Own ☐ Rent ___No. Yrs.		
Mailing Address, if different from Present Address				Mailing Address, if different from Present Address			

If residing at present address for less than two years, complete the following:

Borrower		Co-Borrower	
Former Address (street, city, state, ZIP)	☐ Own ☐ Rent ___No. Yrs.	Former Address (street, city, state, ZIP)	☐ Own ☐ Rent ___No. Yrs.

Borrower | IV. EMPLOYMENT INFORMATION | Co-Borrower

Borrower			Co-Borrower		
Name & Address of Employer	☐ Self Employed	Yrs. on this job	Name & Address of Employer	☐ Self Employed	Yrs. on this job
		Yrs. employed in this line of work/profession			Yrs. employed in this line of work/profession
Position/Title/Type of Business	Business Phone (incl. area code)		Position/Title/Type of Business	Business Phone (incl. area code)	

If employed in current position for less than two years or if currently employed in more than one position, complete the following:

IV. EMPLOYMENT INFORMATION (cont'd)

Borrower			Co-Borrower		
Name & Address of Employer	☐ Self Employed	Dates (from - to)	Name & Address of Employer	☐ Self Employed	Dates (from - to)
		Monthly Income $			Monthly Income $
Position/Title/Type of Business	Business Phone (incl. area code)		Position/Title/Type of Business	Business Phone (incl. area code)	
Name & Address of Employer	☐ Self Employed	Dates (from - to)	Name & Address of Employer	☐ Self Employed	Dates (from - to)
		Monthly Income $			Monthly Income $
Position/Title/Type of Business	Business Phone (incl. area code)		Position/Title/Type of Business	Business Phone (incl. area code)	

V. MONTHLY INCOME AND COMBINED HOUSING EXPENSE INFORMATION

Gross Monthly Income	Borrower	Co-Borrower	Total	Combined Monthly Housing Expense	Present	Proposed
Base Empl. Income*	$	$	$	Rent	$	
Overtime				First Mortgage (P&I)		$
Bonuses				Other Financing (P&I)		
Commissions				Hazard Insurance		
Dividends/Interest				Real Estate Taxes		
Net Rental Income				Mortgage Insurance		
Other (before completing, see the notice in "describe other income," below)				Homeowner Assn. Dues		
				Other:		
Total	$	$	$	**Total**	$	$

* **Self Employed Borrower(s) may be required to provide additional documentation such as tax returns and financial statements.**

Describe Other Income

Notice: **Alimony, child support, or separate maintenance income need not be revealed if the Borrower (B) or Co-Borrower (C) does not choose to have it considered for repaying this loan.**

B/C		Monthly Amount
		$

VI. ASSETS AND LIABILITIES

This Statement and any applicable supporting schedules may be completed jointly by both married and unmarried Co-Borrowers if their assets and liabilities are sufficiently joined so that the Statement can be meaningfully and fairly presented on a combined basis; otherwise, separate Statements and Schedules are required. If the Co-Borrower section was completed about a non-applicant spouse or other person, this Statement and supporting schedules must be completed about that spouse or other person also.

Completed ☐ Jointly ☐ Not Jointly

ASSETS Description	**Cash or Market Value**	**Liabilities and Pledged Assets.** List the creditor's name, address, and account number for all outstanding debts, including automobile loans, revolving charge accounts, real estate loans, alimony, child support, stock pledges, etc. Use continuation sheet, if necessary. Indicate by (*) those liabilities, which will be satisfied upon sale of real estate owned or upon refinancing of the subject property.		
Cash deposit toward purchase held by:	$			
List checking and savings accounts below		**LIABILITIES**	**Monthly Payment & Months Left to Pay**	**Unpaid Balance**
Name and address of Bank, S&L, or Credit Union		Name and address of Company	$ Payment/Months	$
Acct. no.	$	Acct. no.		
Name and address of Bank, S&L, or Credit Union		Name and address of Company	$ Payment/Months	$
Acct. no.	$	Acct. no.		
Name and address of Bank, S&L, or Credit Union		Name and address of Company	$ Payment/Months	$
Acct. no.	$	Acct. no.		

VI. ASSETS AND LIABILITIES (cont'd)

Name and address of Bank, S&L, or Credit Union		Name and address of Company	$ Payment/Months	$
Acct. no.	$	Acct. no.		
Stocks & Bonds (Company name/ number & description)	$	Name and address of Company Acct. no.	$ Payment/Months	$
Life insurance net cash value Face amount: $	$	Name and address of Company	$ Payment/Months	$
Subtotal Liquid Assets	$			
Real estate owned (enter market value from schedule of real estate owned)	$			
Vested interest in retirement fund	$			
Net worth of business(es) owned (attach financial statement)	$	Acct. no.		
Automobiles owned (make and year)	$	Alimony/Child Support/Separate Maintenance Payments Owed to:	$	
Other Assets (itemize)	$	Job-Related Expense (child care, union dues, etc.)	$	
		Total Monthly Payments	$	
Total Assets a.	$	Net Worth (a minus b) ► $	**Total Liabilities b.**	$

Schedule of Real Estate Owned (If additional properties are owned, use continuation sheet.)

Property Address (enter S if sold, PS if pending sale or R if rental being held for income) ▼	Type of Property	Present Market Value	Amount of Mortgages & Liens	Gross Rental Income	Mortgage Payments	Insurance, Maintenance, Taxes & Misc.	Net Rental Income
		$	$	$	$	$	$
	Totals	$	$	$	$	$	$

List any additional names under which credit has previously been received and indicate appropriate creditor name(s) and account number(s):

Alternate Name	Creditor Name	Account Number

VII. DETAILS OF TRANSACTION

a.	Purchase price	$
b.	Alterations, improvements, repairs	
c.	Land (if acquired separately)	
d.	Refinance (incl. debts to be paid off)	
e.	Estimated prepaid items	
f.	Estimated closing costs	
g.	PMI, MIP, Funding Fee	
h.	Discount (if Borrower will pay)	
i.	Total costs (add items a through h)	

VIII. DECLARATIONS

If you answer "Yes" to any questions a through i, please use continuation sheet for explanation.	**Borrower** Yes	**Borrower** No	**Co-Borrower** Yes	**Co-Borrower** No
a. Are there any outstanding judgments against you?	☐	☐	☐	☐
b. Have you been declared bankrupt within the past 7 years?	☐	☐	☐	☐
c. Have you had property foreclosed upon or given title or deed in lieu thereof in the last 7 years?	☐	☐	☐	☐
d. Are you a party to a lawsuit?	☐	☐	☐	☐
e. Have you directly or indirectly been obligated on any loan which resulted in foreclosure, transfer of title in lieu of foreclosure, or judgment? .... (This would include such loans as home mortgage loans, SBA loans, home improvement loans, educational loans, manufactured (mobile) home loans, any mortgage, financial obligation, bond, or loan guarantee. If "Yes," provide details, including date, name, and address of Lender, FHA or VA case number, if any, and reasons for the action.)	☐	☐	☐	☐

VII. DETAILS OF TRANSACTION		
j.	Subordinate financing	
k.	Borrower's closing costs paid by Seller	
l.	Other Credits (explain)	
m.	Loan amount (exclude PMI, MIP, Funding Fee financed)	
n.	PMI, MIP, Funding Fee financed	
o.	Loan amount (add m & n)	
p.	Cash from/to Borrower (subtract j, k, l & o from i)	

VIII. DECLARATIONS	Borrower Yes	Borrower No	Co-Borrower Yes	Co-Borrower No
If you answer "Yes" to any questions a through i, please use continuation sheet for explanation.				
f. Are you presently delinquent or in default on any Federal debt or any other loan, mortgage, financial obligation, bond, or loan guarantee? ………………….. If "Yes," give details as described in the preceding question.	☐	☐	☐	☐
g. Are you obligated to pay alimony, child support, or separate maintenance? …………………………………………………………………	☐	☐	☐	☐
h. Is any part of the down payment borrowed? ……………………………………....	☐	☐	☐	☐
i. Are you a co-maker or endorser on a note? ………………………………………………	☐	☐	☐	☐
j. Are you a U.S. citizen? …………………………………………………………………	☐	☐	☐	☐
k. Are you a permanent resident alien? ………………………………………………….	☐	☐	☐	☐
l. **Do you intend to occupy the property as your primary residence? ……....................** If "Yes," complete question m below.	☐	☐	☐	☐
m. Have you had an ownership interest in a property in the last three years? …………..	☐	☐	☐	☐
(1) What type of property did you own—principal residence (PR), second home (SH), or investment property (IP)?				
(2) How did you hold title to the home—solely by yourself (S), jointly with your spouse (SP), or jointly with another person (O)?				

IX. ACKNOWLEDGEMENT AND AGREEMENT

Each of the undersigned specifically represents to Lender and to Lender's actual or potential agents, brokers, processors, attorneys, insurers, servicers, successors and assigns and agrees and acknowledges that: (1) the information provided in this application is true and correct as of the date set forth opposite my signature and that any intentional or negligent misrepresentation of this information contained in this application may result in civil liability, including monetary damages, to any person who may suffer any loss due to reliance upon any misrepresentation that I have made on this application, and/or in criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Sec. 1001, et seq.; (2) the loan requested pursuant to this application (the "Loan") will be secured by a mortgage or deed of trust on the property described in this application; (3) the property will not be used for any illegal or prohibited purpose or use; (4) all statements made in this application are made for the purpose of obtaining a residential mortgage loan; (5) the property will be occupied as indicated in this application; (6) the Lender, its servicers, successors or assigns may retain the original and/or an electronic record of this application, whether or not the Loan is approved; (7) the Lender and its agents, brokers, insurers, servicers, successors, and assigns may continuously rely on the information contained in the application, and I am obligated to amend and/or supplement the information provided in this application if any of the material facts that I have represented herein should change prior to closing of the Loan; (8) in the event that my payments on the Loan become delinquent, the Lender, its servicers, successors or assigns may, in addition to any other rights and remedies that it may have relating to such delinquency, report my name and account information to one or more consumer reporting agencies; (9) ownership of the Loan and/or administration of the Loan account may be transferred with such notice as may be required by law; (10) neither Lender nor its agents, brokers, insurers, servicers, successors or assigns has made any representation or warranty, express or implied, to me regarding the property or the condition or value of the property; and (11) my transmission of this application as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or my facsimile transmission of this application containing a facsimile of my signature, shall be as effective, enforceable and valid as if a paper version of this application were delivered containing my original written signature.

Acknowledgement. Each of the undersigned hereby acknowledges that any owner of the Loan, its servicers, successors and assigns, may verify or reverify any information contained in this application or obtain any information or data relating to the Loan, for any legitimate business purpose through any source, including a source named in this application or a consumer reporting agency.

Borrower's Signature	Date	Co-Borrower's Signature	Date
X		X	

X. INFORMATION FOR GOVERNMENT MONITORING PURPOSES

The following information is requested by the Federal Government for certain types of loans related to a dwelling in order to monitor the lender's compliance with equal credit opportunity, fair housing and home mortgage disclosure laws. You are not required to furnish this information, but are encouraged to do so. The law provides that a lender may not discriminate either on the basis of this information, or on whether you choose to furnish it. If you furnish the information, please provide both ethnicity and race. For race, you may check more than one designation. If you do not furnish ethnicity, race, or sex, under Federal regulations, this lender is required to note the information on the basis of visual observation and surname if you have made this application in person. If you do not wish to furnish the information, please check the box below. (Lender must review the above material to assure that the disclosures satisfy all requirements to which the lender is subject under applicable state law for the particular type of loan applied for.)

BORROWER ☐ I do not wish to furnish this information	CO-BORROWER ☐ I do not wish to furnish this information
Ethnicity: ☐ Hispanic or Latino ☐ Not Hispanic or Latino	**Ethnicity:** ☐ Hispanic or Latino ☐ Not Hispanic or Latino
Race: ☐ American Indian or Alaska Native ☐ Asian ☐ Black or African American ☐ Native Hawaiian or Other Pacific Islander ☐ White	**Race:** ☐ American Indian or Alaska Native ☐ Asian ☐ Black or African American ☐ Native Hawaiian or Other Pacific Islander ☐ White
Sex: ☐ Female ☐ Male	**Sex:** ☐ Female ☐ Male

To be Completed by Interviewer	Interviewer's Name (print or type)	Name and Address of Interviewer's Employer
This application was taken by: ☐ Face-to-face interview ☐ Mail ☐ Telephone ☐ Internet	Interviewer's Signature / Date	
	Interviewer's Phone Number (incl. area code)	

CONTINUATION SHEET/RESIDENTIAL LOAN APPLICATION

Use this continuation sheet if you need more space to complete the Residential Loan Application. Mark **B** f or Borrower or **C** for Co-Borrower.	Borrower:	Agency Case Number:
	Co-Borrower:	Lender Case Number:

I/We fully understand that it is a Federal crime punishable by fine or imprisonment, or both, to knowingly make any false statements concerning any of the above facts as applicable under the provisions of Title 18, United States Code, Section 1001, et seq.

Borrower's Signature	Date	Co-Borrower's Signature	Date
X		**X**	

The TA should also assist the buyer in gathering the necessary documents to be submitted in conjunction with the loan application. These documents frequently take the form of W2's and recent pay-stubs to evidence the employment information represented by the buyer in section four of the loan application. [See Form 203 (FNMA 1003)]

Other portions of the loan application will need to be later verified by the lender with supplemental documents, such as:

- an appraisal report to establish the value of the property serving as security, as called for in section two;

- recent bank statements;

- verification of deposit or tax returns to establish the buyer's assets, as called for in section six; and

- a credit report to establish the buyer's liabilities and propensity to repay the loan, also called for in section six. [See Form 203 (FNMA 1003)]

The necessity of separate applications to multiple lenders

When a loan contingency exists in a transaction, which is almost always the case in sales of real estate, the buyer will need assistance when negotiating with the lender to ensure he will end up with the most competitive loan rates and terms available. To best achieve this advantage, the TA needs to advise the buyer to consider submitting separate loan applications to multiple lenders, a minimum of two. This is no different than getting a bid on the purchase price of the same automobile from two car dealers, except that substantially more money (and savings) is involved.

By submitting applications to at least two lenders, the buyer is armed with a fail-safe system to bypass unscrupulous changes by the lender, their representatives, or any mortgage loan brokers involved: if one lender's costs and rates change unreasonably at the time of closing, the buyer has another loan application in process with a different competing lender.

Multiple applications keep the lenders vying for the borrower's business. It is competition which assures they remain competitive to the last minute – the moment of funding.

Lenders, of course, do not like to be competitive, much less controlled by antitrust laws. For this reason they instinctively advise buyers not to submit multiple applications for credit, fabricating the claim that additional applications will interfere with debt ratio analysis during loan processing. Lender representatives have gotten good at this.

However, a buyer who submits applications to two lenders has a bargaining chip against a lender who later:

- loads on the garbage fees at the time of closing; or

- is unable or unwilling to originate the loan on the terms initially represented by it, or at the lower prevailing par rate available in the loan market at the time of closing.

Types of loans

The typical conventional loan for homebuyers is the 30-year mortgage with a **fixed rate** of interest which is based on long-term rates.

The buyer's monthly payment remains the same during the life of the fixed-rate loan since the interest rate remains the same. Fixed-rate loans offer greater long-term stability for the homebuyer than do loans with varying interest rates and payment schedules.

However, the qualified buyer is not restricted to the historical fixed-rate, 30-year mortgage. Other options to consider include:

- adjustable rate mortgages (ARMs) where the interest rate changes periodically based on an index for short-term loans, plus a margin, limited by interest rate and payment caps and floors, which cause the buyer's monthly payment to adjust to continue the loan amortization [See Chapter 7];
- rate buy-downs where the buyer receives an initial interest rate which is periodically increased, with the monthly payment adjusted accordingly, to a fixed rate within a few years, called a *graduated payment loan* (GPM);
- the length of the loan, typically loan terms are 15 or 30 years, although some lenders offer 20-, 25- or 40-year loans based on amortization;
- assumable loans allowing resale to a creditworthy buyer, with or without a rate adjustment;
- bi-weekly mortgagees with payments made every two weeks to reduce the total amount of interest paid on the loan;
- private mortgage insurance (PMI) where a qualifying buyer can obtain a loan with less than a 20% down payment while paying a premium for insurance to cover the lender's risk of loss created by the smaller down payment. [See Chapter 40]; and
- *Interest Only PLUS* (IOP) 35 year program in which only interest is paid for the first five years of the loan, then a set fixed rate of interest is paid for the remaining 30 years.

The submission of a loan application to a lender, much less multiple lenders, does not commit the buyer to any obligation to any lender. A lender may only disclose reasonable and competitive estimates and loan terms before and at the time the initial loan application is submitted in order to lure the buyer to stay with them during the loan packaging process. However, the lender has no obligation not to boost its costs, fees or the interest rate at any later stage in the process, usually reserved to a change just three days before closing.

Within three business days after submitting the loan application to the lender, the lender must hand the buyer the lender's GFE of costs. On this form, the lender discloses all loan related charges to be paid by the buyer, such as origination fees, credit report fees, insurance costs, and prepaid interest it intends to charge or be reimbursed for originating the loan. [See **first tuesday** Form 204 (DRE 883)]

If the estimate of costs and rates worked up by the loan representative prior to submission of the loan application are widely divergent from those furnished in the GFE and accompanying Truth-in-Lending Act (TILA) annual percentage rate (APR) disclosures, the lender's true performance colors are instantly exposed. [See **first tuesday** Forms 204 (DRE 883) and 221]

The buyer, with the proper guidance of the TA, can help determine at the time of the disclosures whether the loan representative gave them straightforward and honest information, or if the initial interview with the loan representative was a fabrication to entice the buyer to apply for a loan with them.

To compound this deception, lenders often change their rates and charges immediately prior to closing. When they do so, they hand the borrower a second "refreshed" GFE and TILA (APR) disclosure with modified (more specifically, *increased*) charges and loan terms, presented to be signed at least three business days before closing. [See **first tuesday** Forms 204 (DRE 883) and 221]

If the buyer has not submitted a backup application with another lender, the borrower has no alternative available to protect himself against the lender going in for extra profits at the last possible opportunity. However, by keeping loan applications in the works with two or more lenders and holding negotiations to establish which lender ultimately offers the best terms and rates, the TA is able to direct the buyer to the lender who offers the superior set of loan costs, terms for payment and interest rates. No less is expected by a buyer of his agent.

Although the second application doubles the buyer's application costs, these costs are de minimis in comparison to the total dollar amounts involved in the transaction. The TA should not let the borrower be dissuaded on these grounds.

Multiple government agencies, both federal and state, promote the practice of submitting multiple applications. To assist the buyer with the task of comparing the products of two or more lenders after multiple applications have been submitted, entities such as the California Department of Corporations, Freddie Mac, the Federal Reserve, and the Federal Trade Commission publish *Mortgage Shopping Worksheets*. These worksheets, designed to be completed by the buyer with the assistance of the TA, contain two columnar itemizations of all the variables commonly occurring at the time of origination and over the life of a loan.

After submitting loan applications to two lenders and receiving the corresponding GFE and TILA (APR) disclosures, the buyer will possess all the information needed to fill in both columns, one for each lender. Once complete, the buyer and TA can clearly compare the terms offered by the competing lenders and proceed to close on the more advantageous offer. The California Department of Corporation's Mortgage Shopping Worksheet can be obtained through their website at www.corp.ca.gov.

Fundamentals of the Uniform Residential Loan Application

The Uniform Residential Loan Application prepared by the buyer, with the professional assistance of his TA, supplies the lender with necessary information about the buyer and the property securing the loan. It also gives the lender authorization to start the loan packaging process, activity necessary for the lender to determine whether the buyer is qualified to obtain a mortgage, and if so, on what terms. [See Form 203 (FNMA 1003)]

Generally, the loan would be sought in a sales transaction by a buyer who requires the money to fund the purchase of a property. However, the loan may also be used by an owner of vacant land to construct

Alternatives to conventional loans

Aside from conventional loans which are available to borrowers with a sufficient down payment and a good credit standing, the agent assisting the buyer to obtain a loan should expose the buyer to other types of available financing, including:

- loans insured by the Federal Housing Administration (FHA) which are available to borrowers with a small down payment and less than perfect credit rating [See Chapter 39];
- loans insured by the Veterans Administration (VA) which are available to military veterans; and
- Cal-Vet loans which are available to military veterans living in California.

Each type of loan has unique advantages and disadvantages.

The agent's ability to explain the different qualification requirements for each alternative type of financing helps the buyer make informed choices from among the lenders and loans available to satisfy the loan contingency and close the purchase without being misled.

a dwelling, or used by a property owner to improve or renovate a property he currently owns, or to refinance an existing mortgage. In some instances, the loan could be sought by a tenant on a long-term lease who has agreed to make **tenant improvements** (TIs) to the property he rents.

As can be inferred by its title, the Uniform Residential Loan Application is intended primarily for use on residential property loans, such as one-to-four unit residential property, condominiums (attached or detached), or rental property of any size which is exclusively residential.

However, as a generic loan application, it can be used to apply for a loan secured by any type of property since it contains all the information required for arranging all types of real estate loans. In practice, the type of property intended to be purchased by the loan proceeds is clear based on the description of the property in the loan application.

Components of the Uniform Residential Loan Application

Once the TA has reviewed the loan process with the buyer, now called the **borrower**, the application must be completed and submitted. The application itself is designed to be completed with the loan representative, though it is crucial that the TA also be present during this critical step of the transaction.

The first section of the Uniform Residential Loan Application calls for the borrower, with the assistance of the loan representative, to enter the **type of mortgage sought**, such as conventional, VA or FHA-insured. The borrower must also indicate the total amount of the loan requested, the anticipated interest rate (fixed or adjustable), the periodic payment schedule (constant or graduated), as well as the amortization period (positive or negative).

In the second section, the borrower identifies the property which will be used to secure the loan, as well as the purpose of the loan, such as purchase-assist, refinance, or personal-use equity loan, and the intended use of the property, be it as a primary residence or for investment purposes. The source of down payment funds and closing costs are also to be entered here.

Information relating to the borrower, such as his **name** and **social security number**, is entered in section three. Here, and in section four, space is left to insert any co-borrower information if the liabilities, income or assets of the co-borrower will be considered for loan qualification purposes. If the liabilities, income or assets of a co-borrower are community property, the borrower is also to mark the appropriate community property box at the top of the form.

California is a *community property* state, meaning most assets and liabilities incurred during the marriage are shared between husband and wife, including real estate interests. If community property is not involved in the transaction for which the borrower is applying for a loan, then the spouse is not a co-borrower and that spouse's separate assets cannot be seized by the lender.

If the assets and liabilities are to be considered **community property** (as is generally the case with home purchases by a husband and wife), then the *borrower* is one spouse and the *co-borrower* is the other spouse.

However, a separate application regarding assets and liabilities must be filled out by the co-bo rower and separately submitted to the lender if:

- the assets and liabilities result from separate property owned by a co-borrower;
- the co-borrower is a necessary party to the transaction as the separate property encumbered will be considered community property; or
- the co-borrower is a co-signer of the note as a primary borrower.

The borrower and co-borrower will prepare the Balance Sheet Financial Statement – Assets, Liabilities and Net Worth, **first tuesday** Form 207-1, if their assets and liabilities are sufficiently joined to make one combined statement viable. If not, each co-borrower is to prepare their separate loan application for individual consideration by the lender.

The borrower may later complete the Statement of Information – For General Index, **first tuesday** Form 401-4, to disclose confidential information to be used by the title company to search the general index (GI) for information on the borrower and any co-borrower regarding judgments and other legal difficulties which might interfere with their taking title or providing the security interest in the property required by the lender.

Section four of the Uniform Residential Loan Application calls for the borrower's (and co-borrower's) **employment information** to determine his source of income. Space is provided for the entry of the position currently held by the borrower, his title, and years spent at that specific job and within that profession. The borrower is to mark the checkbox to indicate if he is self-employed. Lenders use this information to determine the financial stability of the borrower, as well as his ability to repay his debts.

Next, in section five, the borrower is to report his **monthly income** and **combined housing expenses**. A self-employed borrower should submit a profit and loss statement or have a printout of one from his company if it is a major source of his income.

The borrower's **assets** and **liabilities** are entered into section six which establishes his net worth. The lender desires detailed information about the borrower's assets and is entitled to know all of the borrower's liabilities as they affect his ability to repay the loan. However, the borrower may not want to

disclose all his assets. Thus, a balance must be struck between maintaining financial privacy and disclosing enough assets (though all liabilities) to the lender to get creditworthiness clearance so the loan will be funded.

In section seven, spanning pages five and six, the borrower is to enter **details about the transaction** the loan will be funding. Items called for include the purchase price of the property if the loan is purchase assist. The price entered should be the net of any rebates or discounts or other allowances received by the borrower whether directly or indirectly, or from the seller or the brokers involved. Also called for in section seven is the cost of repairs, alterations, or improvements made to the property. If the loan is to be used for a **refinance**, the estimated cost would be entered here at section “d”, leaving “a”, “b”, and “c” blank.

Next, in section eight, the borrower (and any co-borrower) makes a declaration of any relevant **miscellaneous creditworthiness issues** which need to be disclosed to the lender, such as debt enforcement or debt avoidance they have experienced.

The ninth section is **signed by the borrower** (and any co-borrower) to acknowledge and agree to the following conditions:

- the information provided by the borrower (and any co-borrower) is true and accurate, and if it is not, informs the borrower of the penalties of misrepresentation;

- a trust deed lien will be recorded on the property described in the application to secure the loan;

- the property will not be used for any illegal purposes;

- the purpose of the application is to induce the lender to lend funds to the borrower;

- the property will be occupied as represented in the application;

- the lender will retain the application whether or not it decides to fund the loan;

- the borrower will amend the application and resubmit it to the lender if the facts originally stated substantially change;

- if the borrower defaults on the loan, the default will be reported to one or more credit reporting agencies;

- the borrower may assign the loan to others, though the borrower will not be able to sell the property subject to the same rights as the lender to assign its position;

- the lender or any of its affiliates has made no representations about the value of the property which will secure the loan if funded;

- an emailed or faxed version of the loan application is equally valid as the printed copy of the form; and

- the lender is authorized to verify all aspects of the loan application as represented by the borrower.

The bottom of the loan application, section ten, contains a non-mandatory portion specifying the borrower's **ethnicity, race and gender**. This portion of the loan application is used by the federal government to monitor the lender involved and ensure its compliance with fair housing, equal credit opportunity, and home mortgage disclosure laws.

The bottom of section ten is to be completed by the loan representative who assisted the borrower to complete the application. The loan representative is to indicate how the application was taken, whether in a face-to-face interview with the borrower, through the mail, over the phone, or via the internet.

Self-employed buyer exposed

The buyer is to mark the checkbox in section four to indicate if he is self-employed. A self-employed buyer is typically required to provide a lender with:

- a signed Internal Revenue Service (IRS) Form 4506 (Request for Copy of Tax Form); [See **first tuesday** Form 215]

- copies of the buyer's income tax returns for at least the past two years; and

- copies of his financial statements. [See **first tuesday** Forms 207 and 207-1]

With a signed copy of **first tuesday** Form 215 (IRS 4506) and copies of the buyer's tax forms, the lender is authorized to confirm with the IRS the authenticity of income information submitted by the self-employed buyer. The lender may, within one year of the date noted by the signature on Form 215 (IRS 4506), request copies of income tax forms previously filed with the IRS. Thus, to put an end to a lender's later inquiry with the IRS after one year, Form 215 (IRS 4506), must be dated by the buyer.

Also, the Department of Housing and Urban Development (HUD) requires a lender who files Form 215 (IRS 4506) with the IRS to report any discrepancies between the information provided by the buyer and the information received from the IRS.

Self-employed buyers may find HUD's requirements disconcerting, fearing the request will trigger a tax audit for reasons not known to the buyer. However, HUD's regulations were initiated to prevent potential borrowers from presenting lenders with phony, unfilled tax documents as verification of their income.

Editor's note — It can take up to 45 days to receive the tax returns requested with Form 215 (IRS 4506). Thus, lenders rarely use the form prior to closing, but do so on a later default to check for fraud, unless the one year period has run.

A buyer can also use Form 4506 to obtain copies of lost W-2 forms. The Internal Revenue Service does not charge a fee for copies of W-2's.

RESPA and TILA disclosures

The Real Estate Settlement Procedures Act (RESPA) mandates lenders active in the secondary mortgage market must disclose all loan related charges on loans used to purchase one-to-four unit residential properties, such as origination fees, credit report fees, insurance costs and prepaid interest.

On adjustable rate mortgages (ARMs), the lender must inform the buyer not only of the interest rate, but also the index, margin and payment and interest rate caps. [See **first tuesday** Form 320]

The RESPA lender must provide the buyer with the following:

- a good faith estimate (GFE) of all loan related charges listed in Section L of the HUD-1 statement within three days after the lender's receipt of the borrower's loan application [24 Code of Federal Regulations §3500.7; see **first tuesday** Form 204 (DRE 883)];
- a copy of the HUD-published special information booklet, titled Buying Your Home – Settlement Costs and Helpful Information, within three days after the lender's receipt of the borrower's application [24 CFR §3500.6]; and
- a HUD-1 or HUD-1A closing statement detailing all charges. [24 CFR §3500.10(b); see **first tuesday** Form 402]

If the buyer is arranging financing through a mortgage loan broker, the broker, not the lender, must provide a copy of the special information booklet to the buyer. [24 CFR §3500.6(a)(1)]

However, the booklet does not need to be given to the buyer if the loan funds for are for:

- the refinance of an existing mortgage;
- a closed-end loan in which the lender takes a subordinate lien;
- a reverse mortgage; and
- any federally related loan that will not be used for the purchase of a one-to-four unit residential property. [24 CFR §3500.6(a)(3)]

Federal TILA disclosures, given to the buyer along with the GFE by the lender within three business days of receipt of the buyer's loan application, are designed to give the buyer standardized loan information for easy comparison of terms between loans offered by different lenders. [See **first tuesday** Form 221]

Reg Z implements the TILA disclosures required on federally defined consumer financing. Consumer financing, also called Reg Z financing or, more clearly, personal-use financing, arises out of:

- real estate loans, their assumptions or refinance;
- personal property loans; and
- carryback financing by dealers.

Situations requiring Reg Z disclosures by the lender to the buyer include:

1. Purchase-assist loans for buyers to acquire property:

   1.1 One-or two-unit residential properties to be occupied by the buyer as his principal residence. [12 Code of Federal Regulations §226.3(a)(4)]

1.2 A vacation home or second home which will be occupied by the buyer more than 14 days during the coming year. [12 CFR §226.3(a)(3)]

1.3 Recreational land to be acquired for the personal use of the buyer. [12 CFR §226.3(a)(3)]

Editor's note – No Reg Z disclosures are required for business, investment, or agricultural acquisitions or for purchase-assist loans for three or more residential units whether or not the borrower occupies. [12 CFR §226.3(a)(4)]

2. Further encumbrance (equity) loans on any type of property already owned by the buyer:

   2.1 Loans funding personal, family, or household uses secured by any type of property. [12 CFR §226.2(a)(12)]

   2.2 Loans funding the maintenance and repair of a one-to-four unit residential property owned and occupied by the buyer. [12 CFR §226.3(a)(4)]

   2.3 Net proceeds from the loan are for deposit into the buyer's personal account. [12 CFR §226.3 (a)(2)]

Editor's note – All other equity loans are exempt from Reg Z disclosures.

3. Refinance of an existing loan on any type of property:

   3.1 A new loan funding the payoff of a loan which was originated or assumed by the owner as a personal-use loan subject to Reg Z. [12 CFR §226.20(a)]

Editor's note – No other refinancing requires Reg Z disclosures, even if secured by the principal residence.

When a loan is subject to both RESPA and TILA, the timing for Regulation Z (Reg Z) disclosures required by TILA are accelerated and included with the RESPA disclosures. The Reg Z disclosures state the terms of the financing and include an itemization of the loan costs incurred by the buyer, including finance charges, interest rates, payment schedules and the APR. [12 CFR §§226.17, 226.18; see **first tuesday** Form 221]

In practice, the RESPA lender originating a personal use mortgage makes the Reg Z disclosures, twice:

- within three days after the lender receives the buyer's loan application; and
- before the buyer signs the loan documents.

The terms of these two disclosures tend to vary from one to another, with the pre-closing disclosure typically containing higher costs and rates than those stated in the lender's original Reg Z disclosure. This inconsistency is the reason a prudent TA should advise his buyer to submit multiple loan applications.

Property appraisal

Once a lender receives a loan application and any processing fee, the property is appraised by a representative of the lender to determine if the property qualifies for a loan. [See **first tuesday** Forms 218 and 228]

The appraisal determines whether the property is of sufficient value to support the amount of financing the buyer requests, principally, whether the loan-to-value (LTV) ratio meets the lender's standards.

Generally, an acceptable LTV for conventional loans is 80% of the property's value, requiring the buyer to make a minimum 20% down payment. A greater LTV compels the prudent lender to require the buyer to obtain private mortgage insurance (PMI).

The lender may reject the loan application by approving a loan of a lower amount if the property value is not adequate to secure the loan amount sought, even if the buyer is qualified to borrow the amount requested. The value limitation is used to limit loan amounts during downturns in the market value of real estate, rather than during a rapidly rising market (as it should). Thus, swings in values throughout an economic cycle are exacerbated by the conduct of lenders.

The loan application package

Once a lender approves property based on an appraisal, a loan package is assembled and sent to a loan committee or underwriting officer for review.

The loan package prepared by the lender includes:

- the loan application [See **first tuesday** Form 207 (FNMA 1020)];
- the property appraisal report [See **first tuesday** Form 200];
- a credit report on the buyer;
- the lender's verifications of the information provided on the loan application [See **first tuesday** Forms 208, 208-1, 209, 210, 210-1, 212, 215, and 215-1];
- the purchase agreement, escrow instructions and condition of property disclosure statement handed to the buyer by the seller and broker [See **first tuesday** Forms 150 and 304]; and
- other documentation needed to support the buyer's request, including operation balance sheets, tax returns, IRS Form 4506, title reports and bank statements.

Post-submission: TA duties still exist

Even after the loan application has been submitted to the lender, the TA's duty to the buyer to continue to oversee the functioning of the lender has not been extinguished.

To program his continued engagement in the transaction, the TA uses the Tracking the Loan Origination Process, **first tuesday** Form 339, to set a schedule with the loan representative for when the loan processing activities are to occur. This form provides the TA with a clear picture of what events are to take place and when, and if they are not timely handled by the lender, provides the TA with the opportunity to get on the phone and remedy the failure and get the process back on track. [See **first tuesday** Form 339]

After submission of the loan application, it is the TA's obligation to police the lender, follow up on his inquiries to the lender's loan representative, and get weekly updates to keep the underlying transaction

on schedule for closing. Since closing the sales transaction is contingent on obtaining a loan, the TA does not want the buyer he represents to lose the deal, and in turn cause the TA to lose his fee, due to any lender inadequacies.

Progress reports from the lender to the TA must be agreed to with the loan representative. This will likely require the buyer to give authority to the lender to discuss the loan handling with the TA. Though the lender will likely resist any attempt to allow oversight of its actions, the buyer's interests are best served by the TA's **continued oversight** of the time set for completion of each stage of the loan packaging process to ensure delays are avoided.

The TA has a duty of care owed to his buyer to protect against known foreseeable harm and loss of money in the form of extra interest and charges taken by the lender.

"Willing and able" to pay

A loan committee or underwriting officer evaluating a loan package considers a buyer's **capacity** and desire to pay. On the loan application, the buyer provides information regarding personal and housing expenses, both current and estimated, and details of the real estate purchase and loan costs.

Generally, the debt-to-income standard for conventional loans, also called the debt-to-income ratio, limits the buyer's:

- monthly payments for the maximum purchase-assist loan, including impounds for hazard insurance premiums and property taxes, to approximately 31% of the buyer's monthly gross income; and

- long-term debt, plus the monthly payments, to approximately 41% of the buyer's gross monthly income. [See **first tuesday** Forms 229-1, 229-2 and 230]

Lenders use debt-to-income ratios to evaluate the buyer's ability to make timely loan payments, called *buyer capacity*. Lenders may approve a higher debt-to-income ratio if a large down payment is made, or the buyer has valuable assets and carries little debt — and when competition between lenders to originate purchase-assist loans intensifies. [See **first tuesday** Form 230]

The buyer's willingness to make his loan payment is evidenced by the credit report. The credit history demonstrates to the lender whether or not the buyer has a propensity to pay, called creditworthiness.

The debt-to-income ratios can be adjusted depending on one or more compensating factors, such as if the buyer has:

- ample cash reserves;

- a low LTV ratio; and

- spent more than five years at the same place of employment.

The buyer's agent should press the lender to his client's advantage if these compensating factors exist.

Loan approval

A loan approval issued by a lender is often conditioned on a buyer providing more necessary information, for example:

- the property's condition may need correction;
- title may need clearing of defects;
- the buyer may be asked to explain or eliminate derogatories on his credit report; or
- the buyer's long- or short-term debt must be reduced.

To obtain final approval and funding, the buyer must correct any problems to the lender's satisfaction.

Once loan conditions are met and verified, the loan is classified as approved. Escrow calls for loan documents and funds, and on funding, the sales transaction is closed.

Agents must constantly remind themselves that what one lender will not accept as a risk presented by the buyer or the property, another will evaluate and set interest rates according to the risk present by the loan requested by the buyer. More often than not, a lender exists who will make a loan of some amount and under some conditions to nearly any buyer. It is the business of lenders to do so.

Chapter 37 — A lender's loan commitment

This chapter analyzes a borrower's reliance on a lender's oral or written commitment to fund a loan.

No responsibility for oral or conditional promises

An owner of industrial land and a manufacturing business he operates on his property applies for a loan from an institutional lender to upgrade and expand his production facilities, and construct additional improvements on the property. The owner has a long-standing business relationship with the lender, having borrowed from them several times over the years.

The lender's loan officer, after processing the loan application, **orally assures** the owner they will provide the long-term financing he will need, called a *take out loan*, to pay off short-term interim financing he will obtain to fund the purchase of equipment and cost of construction. Relying on the lender's oral assurances, the owner enters into a series of short-term loans and credit arrangements with other lenders and suppliers, and begins the planned improvements.

The loan officer visits the owner's plant during the construction and placement of equipment. The officer comments favorably on the work in progress and again assures the owner the lender will provide the long-term financing sought by the owner.

When completed, the owner makes a demand on the lender to fund the permanent financing. The lender refuses, informing the owner the business no longer has the value needed to justify the long-term financing since operating costs and a business recession have decreased the value of the owner's facilities.

The owner is unable to obtain refinancing elsewhere, and the business and real estate is lost on default in the short-term financing. The owner seeks to recover his money losses from the lender, claiming the lender breached its commitment to provide financing.

Can the owner recover damages from the lender?

No! The lender never entered into an enforceable **loan commitment**. Nothing was placed in writing or signed by the lender which **unconditionally committed** the lender to the specific terms of a loan.

Even though the lender orally assured the owner a loan would be funded, and despite the owner's reliance on his pre-existing business relationship with the lender to fund his expansion, the owner was not justified in relying on the lender's oral commitment to fund a loan. [**Kruse** v. **Bank of America** (1988) 202 CA3d 38]

Lenders rarely make written loan commitments. When lenders do, they are limited to federally mandated nonbinding disclosures on single family residence (SFR) loans under Regulation Z, also known as the Truth-in-Lending Act (TILA).

Lenders customarily process applications and prepare loan documents, but they are only signed by the borrower. The lender orally advises the borrower whether the loan has been approved, but signs nothing that binds them. The first and only act committing the lender is its actual funding of the loan — at the time of closing.

Thus, until the lender literally delivers funds and a closing has occurred, the lender can back out of its oral commitment at any time, without liability.

As a result, the balance of power is entirely with the lenders. Thus, mortgage borrowers are forced to rely on unenforceable oral promises when making financial decisions in real estate transactions.

When a lender breaches its oral commitment to lend, the borrower's reliance on anything less than an **unconditional written loan commitment** is not legally justified — even though the borrower had no realistic choice other than to rely on the lender's oral promises.

As a result, prudent borrowers and their agents submit loan applications to more than one lender to guard against these sorts of last-minute surprises.

Commitment upon commitment

The only other course of action a borrower could reasonably undertake is to purchase a **written loan commitment**, paying for the assurance funds will be advanced on the borrower's request. However, these commitments, which are *put options,* are always conditional, never absolute. The lender is allowed to deny a loan even after delivering a written loan commitment to the borrower — again, without liability.

Here's why. A borrower seeks a loan to purchase real estate and the business opportunity located on the premises. The borrower pays $10,000 for a **written conditional loan commitment** from a lender — a letter signed by the lender indicating the lender's intention to fund the loan, based on the satisfaction of a number of conditions, including:

- an appraisal of the personal property and real estate which is to secure the loan;
- the seller, who is carrying back a second, must approve the terms of the loan agreement;
- the borrower must deliver copies of all documents affecting the lender's decision, such as security agreements, guarantees, title reports, trust deeds, and leases, for the lender's approval; and
- approval of the loan by the lender's senior committee.

Later, the lender **verbally assures** the borrower the loan will be funded, stating the members of the senior committee have all approved the loan and all other conditions have been met.

However, when the borrower asks the lender to proceed to close the loan, the lender does not waive the conditions. Ultimately, on demand from the borrower for the funds, the lender refuses to fund the loan.

The borrower is able to obtain another loan from his back-up lender, but on less favorable terms than set out in the lender's written commitment. The borrower seeks to recover his money losses from the lender who refused to fund his loan application, claiming the lender breached its written loan commitment.

The lender claims it did not breach its written commitment since the commitment was conditional.

Can the borrower recover his losses from the lender?

No! Even though the borrower paid the lender for a written conditional loan commitment, the lender never agreed to a final and unconditional written commitment. Thus, the lender escapes liability for failure to perform on its commitment, despite oral assurances to the borrower it would fund the loan agreed in writing. [**Careau & Co.** v. **Security Pacific Business Credit, Inc.** (1990) 222 CA3d 1371]

Chapter 38 — Referral fees: by lender or escrow

This chapter analyzes redundant charges imposed on buyers and sellers for the basic services necessarily rendered by lenders, escrow companies and title insurance companies to earn the primary fee they charge.

The hidden costs surrounding a loan

A homebuyer's obligation to close escrow on a purchase agreement is typically conditioned by a contract provision requiring the buyer to obtain satisfactory **purchase-assist financing**. The loan contingency provision activates two federal mortgage laws which, in addition to California laws, control the disclosures and charges of all **third-party participants** in the sales transaction, called *service providers.* The charges for services rendered by the **service providers** are called *transactional costs*.

Consider a buyer who needs financing to acquire a home. The buyer's real estate agent, called a *transaction agent* by lenders, refers him to a lender whose loan representative claims its costs for originating a purchase-assist loan, called *settlement costs* or *closing/escrow costs,* are the lowest available. The claim of low costs is rooted in the presumption that **interest quotes** from all lenders are the same — which they are not, some are based on *par rates* and others add a *yield spread premium* (YSP) rate for commissions.

After reviewing the loan representative's written **good faith estimate (GFE)** containing his lender's rates, all loan related charges, and third-party settlement costs, the buyer submits a loan application to that lender as mandated by both state and federal mortgage law. The lender is not paid an upfront fee for processing the loan application. [See **first tuesday** Form 204 (DRE 883)]

Three days after submitting the loan application, the buyer receives a second, *refreshed* GFE and a Truth-in-Lending Act (TILA) **Regulation Z disclosure statement** from the lender as required by federal mortgage law on personal-use loans. The TILA disclosure itemizes the specific **loan terms** offered by the lender to the buyer, such as the annual percentage rate (APR), amount financed, finance charges, and interest rate. [See **first tuesday** Form 221]

The buyer discovers the loan closing costs and interest rate now disclosed by the lender in the refreshed GFE and TILA disclosure are substantially higher than previously quoted by the loan representative in the initial GFE given to the buyer.

The buyer and his agent contact the loan representative and question the increased fees and raised interest rate. The buyer insists the lender honor the costs and rate estimates given in the initial GFE which induced him to submit the loan application, since costs and interest rates have not changed.

The lender's loan representative assures the buyer the second GFE and TILA disclosure represent a legal formality which overestimates the actual closing costs and interest rate so figures for a worst case scenario can be provided to potential buyers/borrowers.

The buyer is **not advised** by his agent to:

- submit a back-up loan application to another lender as a precaution; or

- obtain a written representation from the lender's loan representative reconfirming the lower closing costs then stated in the refreshed GFE and TILA disclosure.

The lender processes the buyer's loan application and eventually qualifies the buyer and the property.

The lender's loan representative advises the buyer the loan documents are ready and must be immediately signed and recorded before the end of the month. The buyer is also informed that if the terms of the loan are unacceptable, the loan offer will expire and the loan process will have to start anew next month. The loan representative warns the buyer of the potential for interest rates to rise.

Contrary to the earlier assurances of the lender's loan representative, the buyer's actual loan costs and interest rate on closing are nearly identical to the higher, refreshed GFE and TILA disclosure given to the buyer three business days after submitting his loan application. The buyer now objects to paying the additional fees and the higher interest rate.

The lender refuses to adjust the closing charges and claims the interest rate is the current market rate, taking into account the buyer's discount (prepaid interest) charge, sometimes called *points*. The buyer then turns to his agent for advice. The agent recommends the buyer pay the lender's fees, suggesting they are **customary costs** for a new loan.

The buyer now needs to close the deal and take possession of the property since his family is committed to the purchase and they are beyond the **point of no return**. Thus, the buyer pays the lender's fees and agrees to the higher interest rate, both of which were measurable greater than orally promised by the loan representative and set out in the initial GFE. The transaction closes and the agent is paid his broker fee through escrow.

Is it reasonable for the buyer's agent to allow his buyer to rely on the loan representative's oral representation about the purpose of the post-application GFE and TILA disclosure made by the lender?

No! The lender may charge the buyer the amounts listed on its post-application GFE and TILA disclosure since no change in those charges were made at the time of closing. More importantly, the lender may at the time of closing alter the various charges by merely issuing an amended TILA disclosure or yet another GFE, without regard to the oral assurances given by the lender or its loan representative.

An oral agreement with a lender or its loan representative is not legally binding, nor is the TILA disclosure or GFE. This includes the first copy given to the buyer to induce him to submit a loan application and the second, refreshed copy given three days after submission of the loan application. [**Kruse** v. **Bank of America** (1988) 202 CA3d 38]

A separate, concurrent loan application submitted to another mortgage lender is the best tool available for a buyer to protect himself against lost expectations and overcharges when finally presented with loan documents at the time of closing. Multiple loan applications pit one lender against another in the mortgage market, reducing the tendency of a lender to increase fees and rates when no competing lender exists at the time of closing.

Par rates used for setting the value of a new loan origination are the rates used by mortgage lenders, and vary little from one lender to the next at any time. It is the commissioned loan representative's YSP, a rate of interest the loan representative tacks onto the loan's **par rate** set by the secondary market to increase his compensation for arranging the loan, which artificially increases the rate of interest on the loan. This increase takes place without the knowledge or consent of the loan representative's borrower, the buyer.

However, additional fees, higher interest rates, and miscellaneous charges sought by different lenders and loan brokers at the time of closing will only begin to evaporate — in spite of the law — when the buyer has submitted multiple loan applications to different lenders.

Duplicate charge for same service

Real estate sales transactions during periods of rising property values are increasingly subject to duplicate charges imposed on both buyers and sellers by brokers, lenders, escrow agencies and title companies. **Duplicate charges** for integral services, called *kickbacks* or *hidden costs* based on who ultimately receives the funds, are redundancies constantly experienced by the buying and selling public, in violation of The Real Estate Settlement Procedures Act (RESPA).

Public policy and sound economics suggest that duplicate charges are improper and make the real estate market less efficient. The charging of garbage fees usually results from the systematic elimination of more competent and less costly competition. Also, **kickbacks** to listing and selling brokers (and builders), which are a violation of federal RESPA laws, are openly undertaken by some mortgage lenders, to say nothing about the conduct of the largest title insurance companies, in an illegal effort to garner a greater share of the available business.

Kickbacks are a **corrupting business policy**. Legitimate operators find it difficult to compete with fraud without also stooping to the same fraudulent actions to meet the corrupt competition. Kickbacks, in the form of referral fees or other indirect financial benefits used to steer or capture business, deliberately interfere with the availability of lower rate loans with fewer charges. The buyer is referred to the lender (or title company) who provides the largest kickback, away from the legitimate non-participating competition who will not take part in the consumer fraud.

All brokers and agents in a sales transaction, called *transaction agents*, are prohibited from accepting a **referral fee** for advising parties to employ a particular service provider. The payment of a referral fee by escrow companies, escrow officers, pest control operators, security installers and title insurance companies is specifically prohibited by state law.

Although it should, California legislation does not prohibit the payment of broker referral fees by lenders, or anyone else who renders closing services as a third party in a real estate transaction, if the broker is already collecting a fee for acting on behalf of a principal. Brokers are now limited to merely disclosing to their principal the amount of the referral fee they are receiving. [Calif. Business & Professions Code §10177.4; see **first tuesday** Form 119]

Real estate agents who are employed by a broker (which they must to act as licensees) face a similar prohibition in real estate transactions. Agents acting under their licenses are not permitted to accept a fee or other benefit from any person other than their employing broker, or to pay a fee to any other broker or agent without first directing the payment through their employing broker. [Bus & P C §10137]

For example, an individual licensee, either a broker or sales agent, refers a prospective client to another agent under an agreement to receive one half of the broker fee paid to the agent. While the broker's agent can agree to split the fee, unless prohibited by his employing broker, the agent does so on behalf of his broker.

Thus, the agent must instruct his employing broker to make the payment of the referral fee to the other agent's broker out of the funds earned by the agent as a result of the referral. The agent may not first receive the fee due him from his broker and then pay the referral fee directly to the referring licensee.

Most importantly, the broker or his agent undertaking the representation of a client **must advise** the client of the dollar amount of any referral fee or other benefit they receive from any provider of services arising out of the client's real estate transaction. If the fee or benefit received as compensation for the referral is not disclosed, this non-disclosure is punishable by suspension or revocation of the employing broker's or the agent's license, or both. [Bus & P C §10176(g); see **first tuesday** Form 119]

Double fees, padded charges, same service

Lenders improperly commingle the labeling of all charges listed on loan disclosure estimates as *fees*. In fact, analysis classifies three types of **lender charges**:

- **fees** for lender-performed services integral to the *administrative process* of originating a loan;
- **costs** incurred and paid by the lender and passed on to the borrower for services performed by third parties (such as appraisers and credit reporting agencies); and
- **prepaid interest** in the form of loan discounts and points paid to buy-down the interest rate from the lender's **par rate** or to produce additional earnings for the lender.

Thus, three forms of lender corruption exist:

- fees **charged twice** for the same loan origination service, usually fragmented into several listed services, the aggregate of which are simply the minimum necessary loan origination activities continuously performed by lenders in every loan transaction;
- **padded charges** which overstate the lender's actual out-of-pocket costs for third party services, or are paid to third parties for steering business to lenders; and

The interest rate game

Another abuse practiced by some lenders, particularly their commissioned loan representatives, during the loan processing period arises out of interest rate "lock-in" agreements.

It is understood that interest rates fluctuate daily during the loan application process. However, at any point in the loan application process, the lender may offer to freeze (lock-in) the interest rate for the buyer.

A rate lock-in is beneficial to the lender when interest rates are in a declining mode. Thus, lenders will advise buyers to lock-in the rate when interest rates are declining, ironically based on the stated logic they will rise again, which of course they will.

Conversely, a buyer who agrees to lock-in the rate in a rising interest rate market should obtain a **written lock-in agreement** from the lender regarding interest and points.

A lender orally promising to lock-in the interest rate (whether it is rising or falling) can later refuse to honor their commitment to the rate since an oral agreement with a lender is unenforceable. [Kruse, *supra*]

- **higher interest rates** charged on loans than the lender's par rate to provide the lender with earnings in the form of a YSP taken through **table funding** or later resale of the loan.

RESPA bars second-fee, same-service scams

All **providers of services** to buyers and sellers to open and close a real estate transaction which involves the origination of a *federally-related loan* must comply with the requirements of RESPA, also known as *Regulation X*.

A **federally-related loan** which triggers the control of costs under RESPA is a loan originated and secured by a trust deed lien on:

- one-to-four unit residential property; or

- manufactured housing;

WHICH IS

- made by a lender who annually invests or originates loans retained in the lender's portfolio totaling over $1,000,000;

- made by a federally insured bank or thrift;

- eligible for purchase in the secondary mortgage market by the Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) or the Government National Mortgage Association (Ginnie Mae); or

- is insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA). [24 Code of Federal Regulations §3500.2(b)]

For example, RESPA establishes a *no-new-service, no-second-fee* restriction on the earnings a transaction agent, lender, mortgage loan broker, or escrow or title insurer, called a *service provider*, while rendering services on behalf of a buyer or seller in a real estate transaction financed by the origination of a RESPA loan. These transactions are typically single family residences (SFRs) bought with funds from a purchase-assist loan.

Service providers may charge a fee in any amount reasonably related to the bundle of *general services* included in their basic fee, whether the fee is for brokerage, escrowing, loan processing, appraisal reports, pest control or home inspection reports, attorney's fees, or a title search. The basic fee is almost always permitted to be charged, no matter the amount, for these settlement services. Competition among providers offering the same services will keep the buyer, seller or borrower from being overcharged for transactional costs – the goal of RESPA.

For a fee to qualify as a charge for a *settlement service* and be collectible by a broker, escrow or lender from a buyer, seller or borrower in a RESPA transaction (purchase-assist loan on the sale of one-to-four residential units), the services performed by the broker, escrow, or lender must:

- directly benefit the buyer, seller or borrower; or

- be performed at or before the closing. [**Cohen** v. **J.P. Morgan Chase & Co.** (2nd Cir. 2007) 439 F3d 111]

Further, any fee charged in addition to the basic fee for services performed at or before closing can not be a **surcharge** for:

- an itemized service which duplicates any part of the *general services* implicitly rendered in exchange for the **basic** brokerage fee, escrow fee or loan processing fee, and thus increases its price;

- general *administrative costs* of the broker, escrow, or lender for transaction coordinators, bookkeepers, business insurance, furnishings, fee sharing, broker-mandated trade union dues and other operating overhead, costs implicitly covered in the basic brokerage fee, escrow fee or loan processing fee, or activities such as regulatory compliance requiring employee oversight/supervision and file maintenance;

- *improved services* by upgrades in training, online assistance, equipment or graduating office rent to better support the buyer, seller or borrower; or

- *assisting* buyers or sellers *to locate* property or prospective buyers through advertising, discounted fees, referral fee sharing and the like.

Before a broker, escrow, lender or other provider of services may collect a fee for any **separately listed service**, a.k.a. garbage fees or junk fees, paid in connection with the **creation and closing** of a RESPA controlled real estate transaction, an *underlying basis* must exist to support that separate fee. Unless an underlying basis for the fee exists, the service will be barred as a violation of RESPA.

If the service itemized as the additional junk fee is a service the broker, escrow or lender renders to most buyers, sellers or borrowers in the creation or closing of the sales transaction, the additional fee is barred as a **duplicate charge** since the service is implicitly included and thus paid for in the basic fee which, if allowed, would simply increase the price of that service, a prohibited double-pricing activity.

For the additional brokerage/escrow/loan fee with its separately stated service to be collectible, the service itemized must be another and different service – **extra service** – not *normally provided* to most buyers, sellers or borrowers prior to or at the close of the sales transaction. If the itemized service is a service normally performed and integral to the completion of the services the broker/escrow/lender agreed to render, then it is a **basic service** covered implicitly in the basic charge for the services of the provider – the broker, escrow, lender, title company, etc, and is thus uncollectible.

In the end, RESPA merely requires the provider of services, be he the broker, escrow, lender or others, to adjust their basic fee to cover their costs and allow for a profit; not to add miscellaneous junk fees as surcharges to increase the revenues they receive for what actually is part of their basic service.

With **one-tier pricing**, the customer can compare the advertised fee for the list of services to be rendered, one broker's services against another's, without the nickel-and-dime effect of surcharges to add the maze of a "bonus feature," a deceit upon the public.

Consider a prospective buyer who enters into a listing agreement with a selling broker. A 3% broker fee due on closing is negotiated for finding a suitable property for the buyer. The broker locates a suitable one-to-four unit residential property, the purchase of which will be financed by a federally related loan, subjecting the transaction to RESPA.

On closing, the broker charges the buyer an additional fee, a surcharge to defray his overhead costs (transaction agent) in addition to the agreed-to 3% broker fee. The buyer refuses to pay the surcharge fee, claiming it violates RESPA's **no-new-service, no-second-fee** prohibition since no additional, beneficial service was provided by the broker to support the fee.

Can the broker surcharge the buyer a fee for basic services which are normally provided by the transaction agent when representing a buyer?

No! The surcharge fee violates RESPA's no-new-service, no-second-fee regulation since no additional service was provided. Thus, no additional settlement service fee – the surcharge – was "earned" by the broker to be charged the buyer. [**Busby** v. **JRHBW Realty, Inc.** (April 20, 2009) __ F.Supp__]

Further, a lender or mortgage loan broker is prohibited from paying a fee to a commissioned transaction agent who represents the seller or the buyer in a sale which will be funded by a RESPA loan, unless the transaction agent performs significant services on behalf of the lender for which the fee is paid. Thus, a transaction agent (the broker) may **receive** a **second fee** if he renders significant loan origination services which would otherwise be performed by the lender.

A second fee cannot be paid to any transaction agent simply for directing the buyer to the lender who will make the loan. That type of referral fee, a second fee on the same transaction without more than the effort of referring, is illegal to pay or receive.

For example, a broker and his agent are entitled to a **second fee** in a sales transaction if the fee is for their handling the loan escrow or processing the loan application and loan documents. These services are significant since they are not normally performed by a transaction agent (broker) as part of their representation of buyers and sellers. They are additional closing services provided under separate contracts from the listing employments in a sales transaction.

Conversely, the advice and counsel given a buyer or seller as to which lender (or escrow, title insurance company, etc.) to use is part of the assistance and services expected by clients for the basic brokerage fee compensation the transaction agent receives on the sale.

A lender and transaction agent (broker) are in compliance with the no-new-service, no-second-fee rule if the earnings the broker is to receive for the **second service** were due as:

- payment for **goods**; or
- payment for **services rendered**, other than the referral. [12 United States Code §2607(c)]

A transaction agent can be paid and accept an additional fee for a **second service** he performs, such as a fee paid by a lender to the sales broker (or agent). However, the broker or the agent acting as a transaction agent must perform at least **five** loan origination activities normally performed by the lender or a loan broker to justify the fee. Further, if sufficient loan origination activities are performed by the transaction agent, then the second fee must be further *justified* as a dollar amount others would be paid to competitively perform the same services.

A minimum number of **loan origination services** must be performed by the transaction agent before any fee is *justified*. Consider a transaction agent who initiates the performance of loan services by assisting the buyer in the preparation of the loan application to be submitted to the lender. To justify receipt of the second and loan related fee, the transaction agent must perform at least five of the following loan origination services:

- pre-qualify the buyer/borrower to determine the maximum loan amount he can afford by analyzing the buyer's/borrower's income and debt [See **first tuesday** Form 230];

- advise the buyer/borrower on the home-buying and purchase-assist loan process, about the different types of loans available, and the variations in costs, rates, and payments on the various loans;

- gather financial information from the buyer/borrower such as tax returns, profit and loss statements, bank statements, and balance sheets needed to complete the application process;

- order out verifications of employment and cash deposits [See **first tuesday** Forms 208, 208-1 and 209];

- order out requests for loan verification on other debts owed by the buyer/borrower [See **first tuesday** Forms 209, 210, 210-1 and 211];

- order out the appraisal to determine the property's fair market value (FMV) [See **first tuesday** Form 228];

- order out property inspection and engineering reports [See **first tuesday** Form 130];

- review with the buyer/borrower the process for clearing credit problems which might arise;

- apprise the buyer/borrower, broker, and lender of the status of the application, and what further information or documentation each needs to close, by continuing to conduct regular contacts after taking the loan application until the close of the transaction [See **first tuesday** Form 339];

- order out legal documents (statements) which are required for escrow to close, or a policy of title insurance to be issued;

- order out a flood hazard report on whether the property is located in a flood zone; and

- assist as an active participant in the closing of the loan. [HUD Policy Statement 1991-1, Section C]

However, if the five loan origination activities performed are **related only to counseling** (as contrasted to loan documentation efforts), then the sales transaction agent must:

- present and advise the buyer/borrower on the availability of loans from at least three different lenders (to avoid steering the buyer/borrower to a single lender);

- be paid a fee for his counseling services regardless of which lender is ultimately selected by the buyer/borrower; and

- inform the buyer/borrower that the fee paid for the transaction agent's loan origination services is a competitive rate based on the value of the services rendered, and not contingent or based on the loan amount or type of loan originated with the referred lender.

Profit from the yield spread premium (YSP)

Consider a buyer of real estate who contacts a loan broker for a purchase-assist loan. The loan broker assists the buyer in completing the loan application, counsels the buyer on loan programs, requests and gathers financial data on the buyer, analyzes the buyer's debt and income ratios, arranges appraisals and inspections, and prepares and hands the buyer RESPA disclosures, Reg Z disclosures, and other required notices. The loan broker then submits the loan package to a lender for approval and funding. [See **first tuesday** Forms 201 and 202]

For his compensation, the loan broker enters into a listing agreement with the buyer calling for a 1% loan origination fee for his services. The lender who will fund the loan publishes a daily **rate sheet** in which the lender offers to also pay the loan broker a fee.

The amount of the fee from the lender is based on the *present worth* of the **spread** between the lender's par rate quoted for the loan and the note rate the loan broker negotiates with the buyer, a difference in the value of the loan called the *yield spread premium (YSP)*. Total compensation paid by the buyer and the lender to the loan broker is around 2.5% of the loan amount. [See **first tuesday** Form 104]

After closing, the buyer determines the interest rate on his new loan is a little above the rate charged on other loans originated at the same time. The buyer then discovers the loan broker he employed received a kickback from the lender for the value of the YSP, a fact which was not previously disclosed by the loan broker or lender.

The buyer claims the loan broker's compensation which included the YSP was not agreed to and must be returned to the buyer since it constituted a kickback prohibited by RESPA and state agency law – the loan broker had "sold" the buyer a higher loan rate in order to earn an additional undisclosed and unapproved fee.

The loan broker claims the total compensation received for the services rendered to the lender by preparing the loan package was reasonable and not excessive, and thus not a violation of RESPA.

The buyer claims that compensation exceeding the agreed-to 1% origination fee and costs is excessive.

Has the loan broker violated RESPA by collecting a YSP from the lender?

No! The loan broker has provided compensable loan-related services for payment of the YSP. The buyer is unable to show that the loan broker's total compensation, inclusive of YSP, exceeded fees charged by competing loan brokers for the same services at the time. [**Dominguez** v. **Alliance Mortgage Company** (2002) 226 F. Supp2d 907]

However, a loan broker retained by a borrower must, under state agency law, disclose to his borrower all compensation he receives, from any source, when the earnings flow from the employment by his principal, the borrower. If not disclosed, the borrower can recover the entire fee the loan broker received on the transaction. This recovery of all fees paid to the loan broker also applies to a sales broker and his agent who are paid an undisclosed referral fee. [See **first tuesday** Form 119]

The broker-lender knot

This scenario is further aggravated by the conflicting *adversarial relationship* which legally exists between the buyer's selling agent, whose duty of care is owed to the buyer, and the lender, with whom the buyer's agent collaborates in the sales transaction to receive additional earnings. The buyer's agent has an obligation to the buyer to fully disclose any self dealings and additional compensation received in the transaction (such as the referral fee) to avoid violation of state agency law.

In the context of a real estate purchase, the buyer's agent is the buyer's most reliable and knowledgeable ally. This alliance extends beyond the moment the purchase agreement offer is accepted to all critical interactions with the lender who will fund the closing. The lender is not an agent of the buyer, but his **adversary**.

By negotiating a fee arrangement with the mortgage lender, the buyer's agent aligns himself with the lender, who is a hostile third party with a financial interest economically adverse to the buyer in the purchase transaction negotiated by the agent. [Kruse, *supra*]

The only fee a loan broker should charge, in addition to reimbursement for third-party provider costs, is an **administrative/processing fee** for the loan broker's non-interest earning activities performed prior to recording the loan. **Points and discounts** are the prepayment of interest on the loan, not compensation for arranging and making the loan.

Origination activity for which the loan broker charges a processing fee must, by necessity, include all the basic services required of the loan broker to actually arrange a loan, such as review the loan application, underwriting risk analysis, processing loan documents, and funding the loan, in addition to any other services the loan broker customarily performs to originate a loan.

Consider these basic rules: All real estate brokers and their agents are prohibited from knowingly underestimating lender closing costs. A selling broker's silence in the face of known lender misrepresentation to the buyer constitutes a breach of his agency duty. Additionally, it is the **selling (buyer's) agent's duty** to locate the best possible financial advantage readily available to the buyer – his client. [Bus & P C §§10176, 10177]

Yet, ironically, buyers are all too often left by their selling agents to single-handedly wrestle with the only adversarial element remaining at the time of closing, the lender who will fund the closing and has no duty to anyone but itself. [**Drennan** v. **Security Pacific National Bank** (1981) 28 C3d 764]

The selling agent, best fulfills his agency duty to his client by:

- bargaining with multiple lenders rather than forming a solitary alliance with a single lender or allowing only one loan application to be submitted, a condition where the buyer will, out of necessity, have to accept the terms of that lender at the time of closing;

- enlarging the number of lenders he regularly bargains with to obtain the most affordable and advantageous loan package for his clients (commonly called *working the marketplace*); and

- understanding that all oral representations made by lenders or their loan representatives to the agent or the client are worthless, unless put in writing and signed by the lender's representative.

Any of the following fees listed in addition to an administrative fee are **duplicate charges**:

- **document preparation fee**: for preparing the loan documents needed to originate the loan;

- **loan application fee**: for examining the buyer's credit history and determining whether he qualifies for the loan (typically, the charge for this service is part of, or credited to, the loan administrative processing fee rather than charged separately);

- **processing fee**: for the preparation of loan-related documents;

- **underwriting fee**: for lender's risk analysis and loan approval before funding a loan; and

- **warehousing fee**: for the mortgage lender's acquisition of money on a line of credit extended by a bank so it can fund the loan.

Fees for **inflated costs** incurred by the lender and passed on to the buyer include:

- **appraisal fee**: appraisers are paid $250 to $500 by the lender, depending on the value of the property in question, while the lender passes the appraisal cost on to his borrower at an increased amount;

- **credit report fee**: for obtaining the buyer's credit and telecheck report from a credit reporting agency (agencies typically provide credit and telecheck reports for around $10, while lenders generally pass on the charge at $70 or more); and

- **funding/wire fee**: charged by the lender for the transfer of funds from one account to another (the wire transaction itself costs around $15, while the lender generally passes on the charge at $50 to $300).

Lenders occasionally omit or misrepresent fees during the initial GFE prepared to induce a buyer to submit a loan application. Sensing their advantage in real estate transactions where **timing is everything**, lenders later add and increase fees by including them on the final (amended) GFE and TILA disclosure at the time of closing. At that moment in time, it is too late for the buyer to change lenders or successfully challenge the increased fees.

A competent buyer's agent managing the buyer's activity can prevent some of these unscrupulous charges from occurring. What must be understood by the buyer's agent is that the lender's product – money – is unpriced until closing. This holds true in spite of the GFE and TILA interest rate disclosures that are given to the buyer within three business days following the lender's receipt of the loan application. [See **first tuesday** Forms 204 (DRE 883) and 221]

The most competent buyer's agents have experience policing lenders and are aware of the methods they use to glean the highest rates, most points and garbage fees from the unprotected buyer. If the lender's tactics are anticipated by the buyer's agent, he can counsel the buyer to be on guard against any form of deceit. By doing so, the buyer's agent prevents the lender from pulling the wool over the buyer's eyes, as history has proven they are prone to do.

Lender disclosure requirements

A lender who makes a loan which funds the purchase of one-to-four unit residential property must provide the borrower with a **GFE** of all the *transactional costs* as mandated by RESPA within three days after the lender's receipt of the borrower's loan application. [12 CFR §226.19; see **first tuesday** Form 204 (DRE 883)]

Thus, if the loan funds a personal-use loan, such as a purchase assist loan for a principal residence, TILA disclosures regarding the *loan terms* are presented to the borrower by the earlier of:

- three business days after receiving the borrower's loan application (which is set by the time limit for presenting RESPA GFE cost disclosures); or
- prior to entering into a loan agreement, usually the loan escrow instructions. [12 CFR §226.19(a)]

These TILA loan disclosures include statements informing the buyer of:

- any possibility of interest rate or payment adjustments (variable rates);
- the formula used to make these adjustments;
- the manner in which the interest rate and payments will be determined; and
- the frequency of changes in the interest rate. [12 CFR 226.19(b)]

The purpose of TILA disclosure requirements is to promote homeownership through informed use of consumer credit and to discourage unnecessary or hidden costs to be charged to the buyer during a loan transaction. These objectives are accomplished through a comparative analysis by the buyer as provided by the lender's use of a uniform set of disclosures made by all competing lenders. [12 CFR 226.1(b); see **first tuesday** Form 221]

Although federal disclosure requirements are imposed to protect borrowers, the protection afforded is extremely limited.

For example, the lender may still alter the *loan terms* even after the original TILA disclosure has been delivered to the buyer. If the lender later changes the loan terms in a way which affects the interest rate and payments, the lender is merely required to issue a new TILA statement prior to funding the loan.

The **redisclosure requirement** at the time of funding does not apply when the lender alters any other loan terms, such as an increase in service charges for originating the loan. [12 CFR §226.19(a)(2)]

Erroneously, many buyers are not advised by their agents to shop around and contact multiple lenders for purchase-assist loans. Thus, the internet has become the alternative source of brokerage advice for buyers, and provides an expansive source of loan information (also available to curious real estate agents).

Multiple government agencies, both federal and state, promote the practice of submitting multiple applications. To assist the buyer with the task of comparing the costs and rates of two or more lenders, agencies such as the California Department of Corporations, Freddie Mac, the Federal Reserve, and the

Figure 1

ADJUSTABLE RATE MORTGAGE (ARM) DISCLOSURE WORKSHEET

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

This ARM worksheet discloses the terms of a loan plan entitled: ____

from ____ (Lender) by _______________________________ (Loan Rep.)

for property referred to as: ____

INTEREST RATE:

1. The Note Rate of interest for this loan is comprised of a percentage figure from the selected rate index and the life-of-loan percentage margin agreed to. When the rate index figure changes prior to a scheduled adjustment in the note rate, the change will be reflected in an increase or decrease in the note rate on your loan.

2. The Note Rate is adjusted each ________ month(s) with the first adjustment_____________________________.

2.1 Each Note Rate adjustment is ☐ unrestricted, or ☐ capped to increase no more than ______% or decrease no more than ______%.

2.2 During the life of the loan, the interest rate will not exceed ______% (the Note Ceiling Rate) and will not be less than ______% on your loan.

3. The initial interest rate is 1% and is not based on a rate index figure or the lender's margin rate for this loan.

3.1 The initial interest rate is in effect for a period of ______ month(s).

4. *Note rate* for this loan is calculated as follows: (index + margin = Note Rate)

4.1 Rate index name ____

4.2 Rate index percentage figure (current) . . . . ______%

4.3 Percentage margin offered by lender (constant) . . . . (+) ______%

4.4 **Note Rate** of interest (current) . . . . (=) ______%

4.5 The Note Rate will be adjusted if a change occurs in the rate index figure (§4.2 above).

PAYMENT SCHEDULES:

5. ☐ Full amortization at all times during the life of the loan is a feature of this loan.

5.1 The life of this loan is for a term of ______ years.

5.2 Monthly payment due during the initial ______ month(s) of the loan will be $_____________.

5.3 The amount of the monthly payment will be adjusted each ______ month(s) during the life of this loan.

5.4 The first adjustment in the amount of the monthly payment will occur ____________________________.

5.5 The amount of the monthly payment at the Current Note Rate (§4.4 above) of ______% would be $_____________.

5.6 The amount of the monthly payment at the Note Ceiling Rate (§2.2 above) of ______% would be $_____________.

5.7 The amount of the monthly payment on a 15 year amortization payment schedule at the Note Ceiling Rate (§2.2 above) would be $_____________.

6. ☐ Interest only payments are a feature of this loan. This interest only payment schedule feature avoids any build up in principal through negative amortization.

6.1 The amount of the monthly payments on this loan will be adjusted each ______ month(s) during the ______ year life of the loan, with the first adjustment to occur _______________.

6.2 Interest-only payments may be made on this loan during the initial ______ month(s) of the loan's ______ year term.

6.3 Following the interest-only payment period, the principal balance of the loan will be amortized over the remaining ______ years of its term.

6.4 Monthly payments at the Note Ceiling Rate (§2.2 above) of ______% would be $_____________.

7. ☐ Build up of the principal amount borrowed is a feature of this loan. Minimum monthly payments prior to resetting the payment schedule to fully amortize the loan over its remaining life leaves accrued interest unpaid which is added monthly to principal increasing the loan balance upon which interest thereafter accrues.

7.1 The amount of the monthly payment is adjusted each ______ month(s) with the first adjustment on _______________, unless the principal balance of the loan previously reached ______% of the loan's original principal amount and reset the amount of the payments.

7.2 Increases in the amount of the monthly payment are ☐ unrestricted, or capped to increase no more than ______% each ______ months, until _______________, or the month the principal balance of the loan reaches ______% of the loan's original principal amount, when the monthly payments reset to fully amortize the loan over its remaining term.

7.3 The minimum amount of the initial monthly payment for this loan is $_____________ payable until the first adjustment in payments.

7.4 The amount of the monthly payment you would be required to pay to amortize this loan over 27 years at the Note Ceiling Rate (§2.2 above) of ______% when the principal balance reaches ______% of the original loan amount would be $_____________.

a. The amount of the monthly payment required to amortize a loan balance of ______% of the original loan amount over 27 years at the Current Note Rate (§4.4 above) of ______% would be $_____________.

8. LOAN ASSUMABILITY:

8.1. A due-on-sale clause ☐ does, or ☐ does not, exist in the trust deed.

8.2 Conditions for consent to an assumption on a resale:

____

____

____

____

____

____

9. PREPAYMENT PENALTY:

9.1 A prepayment penalty ☐ does, or ☐ does not, exist.

9.2 If a prepayment penalty exists, for what period does it apply? ______________________________

9.3 The amount of the prepayment penalty may not exceed ☐ six months interest at the Note Rate on the sum of the remaining loan balance less 20% of the original note amount on any payoff within the first five years, or ____.

10. CONVERTIBLE TO A FIXED RATE:

10.1 The loan ☐ does, or ☐ does not, provide for convertibility to a fixed rate loan at the borrower's election.

10.2 If convertibility exists, during what period after origination may the loan be converted?_________________

a. What rate index is used to calculate the fixed rate?_____________________________________(name)

b. What is the amount of the margin used to calculate the Note Rate on conversion? __________

c. Are there points? ______; fees? ______; or other charges on conversion? _______________

11. Borrower's future monthly salary expectation:

11.1 first year: $_____________ monthly amount.

11.2 second year: $_____________ monthly amount.

11.3 third year: $_____________ monthly amount.

12. ☐ A copy of the proposed note is attached.

I have reviewed the loan terms and probable consequences with the buyer.	**I have received a copy of this disclosure worksheet and have reviewed and understand the terms of this loan.**
Buyer's Selling Broker: ______________________	Date:_____________, 20______
By: ______________________	Buyer's Name: ______________________
Phone: ______________________	Buyer: ______________________
Fax: ______________________	Buyer: ______________________
Loan Rep: ______________________	
By: ______________________	
Phone: ______________________	
Fax: ______________________	

Federal Trade Commission publish *Mortgage Shopping Worksheets*. These worksheets are designed to be completed by the buyer with the assistance of the buyer's agent. They contain two columns for itemizing all the variables commonly occurring at the time of origination or over the life of a loan.

After submitting loan applications to two lenders and receiving the corresponding GFE and TILA Reg Z disclosures, the buyer and his agent will possess all the information needed to fill in the columns, one for each lender. Once complete, the buyer and his agent can compare the terms offered by the competing lenders and proceed to act on the more advantageous offer. Information on available terms offered by different lenders can also be gathered from loan representatives and analyzed before submitting applications.

The California Department of Corporation's **Mortgage Shopping Worksheet** can be obtained at www.corp.ca.gov.

Avoiding unnecessary lender fees

A homebuyer can take steps to avoid unnecessary fees and stress caused by the lender, such as:

- seek out financing and pre-approval for a loan by a direct lender prior to entering into a purchase agreement with a seller;
- submit loan applications to **two** lenders on entering into a purchase agreement;
- attempt to advance only the lender's out-of-pocket costs (credit and appraisal reports) prior to funding of the loan, and then only after receiving the lender's GFE disclosure;
- consider offering the seller carryback financing as a less expensive alternative to a new loan; and
- demand signed estimates of interest rates (Reg Z related) and loan origination costs (RESPA related) from the lender's representative. If an adjustable rate mortgage (ARM) is arranged, the buyer must request an ARM disclosure statement be filled out by the lender's representative. [See Figure 1]

By submitting loan applications to **two lenders,** the buyer can:

- select the lender who, through comparative shopping, offers the best loan terms at the time of closing;
- lock-in the interest rate on one loan (in writing) and not lock in the other loan, which is subject to daily interest rate fluctuations; and
- negotiate with the lenders at the time of closing for fewer fees, using pre-application GFEs by the loan representatives as a wedge.

Lenders, of course, do not like to be competitive. Thus, they instinctively advise buyers not to submit multiple applications for credit (which will occur on multiple loan applications), wrongfully claiming additional applications will interfere with debt ratio analysis during the loan processing.

A buyer who submits applications to two lenders has retained a bargaining chip to protect himself against a lender who later:

- loads on the garbage fees at the time of closing; or
- is unable or unwilling to originate the loan on the terms initially represented by it, or at the lower prevailing **par rate** available elsewhere at the time of closing.

The submission of a loan application to one lender, even multiple lenders, does not commit the buyer to any obligation to any lender. Though a lender may disclose reasonable and competitive cost estimates (RESPA) and loan terms (TILA/Reg Z) before and at the time the initial loan application is submitted, luring the buyer to stay with them during the loan packaging process, the lender has no obligation not to boost its costs, fees or the interest rate at any later stage in the process, usually reserving these boosts for three days before closing.

If the estimate of costs and rates worked up by the loan representative prior to submission of the loan application are widely divergent from those furnished in the GFE and accompanying TILA annual percentage rate (APR) disclosures, the lender's true colors are instantly exposed. The buyer, with the proper guidance of the buyer's agent, can determine whether the loan representative gave them straightforward and honest information, or if the initial interview with the loan representative was a fabrication to entice the buyer to apply for a loan.

Although the second application doubles the buyer's application costs, these costs are minimal in comparison to the total dollar amounts involved in the transaction. The buyer's agent should not let the borrower be dissuaded on these grounds as this cost is the premium paid for covering the risk of changes at closing.

Escrow fees for "extras"

Escrow agents are subject to RESPA cost controls when a one-to-four unit residential property is the subject of their sales or loan escrow. Yet escrows have also jumped on the hidden-cost bandwagon by adding fees, but not additional services.

Rather than openly admitting to fee hikes and risk losing business to competitive RESPA compliant escrow officers, escrow companies generally advertise a low rate for **basic services**, and upon closing charge for services proclaimed as *extras*.

Extras are most frequently **fundamental services** necessary to the escrowing of every transaction. These necessary services are often separately itemized as additional charges as though the service was especially unique to this transaction and not a service performed as a necessary step. However, these charges are merely a duplication or redundancy of services necessarily performed as part of the basic service fee since the separately itemized services are an integral part of the services required to be performed by an escrow officer in every escrow.

Some escrow companies are vague with their definition of what services are included in a basic escrow transaction. However, basic escrow service includes any activity required of escrow in the routine services expected and rendered in most every transaction.

Duplicate fees commonly charged by escrow agents include:

- fees for drawing deeds and notes;

- a fee for complying with lender instructions and handling the lender's documents;

- an Internal Revenue Service (IRS) §1099 processing fee charged for filing a tax form (which is also separately prohibited) [Internal Revenue Code §6045(e)(3)]; and

- fees for notarizing signatures (which if allowed are limited to $10 per signature when performed at the escrow office). [Calif. Government Code §8211]

The fundamental events which constitute an escrow include:

- the receipt of funds from the buyer and lender (and, if deposited with a title company instead, any sub-escrow charge should be absorbed by escrow as a deduction from the client's escrow fee since the escrow did not handle the money which is a most normal function of escrow);

- preparation of the seller's grant deed and any carryback note and trust deed; and

- preparation of instructions for escrow's delivery of funds and documents on satisfaction of conditions, called an *escrow.* [Calif. Civil Code §1057]

Thus, the most basic escrow services — after preparing written instructions — are preparing deeds, notes and trust deeds, handling funds and documents from the buyer and the buyer's lender, ordering out reports and statements needed by escrow to comply with instructions and releasing all instruments on the close of escrow. One can recognize inclusive services by reviewing the boilerplate escrow instructions.

An escrow officer should be asked to provide a notary seal at their office. The office-place notary acknowledgment is capped by law at $10 per signature. However, notaries happily prefer to meet at the buyer's place of business or home, and then charge $100.00 or more per signature.

Any escrow company itemizing the above services separately from the basic service is double charging for a single basic service, a RESPA violation when a federally related loan is involved. These services by an escrow agent are simply the minimum activities required to open, process and close an ordinary sales escrow.

Chapter 39 The FHA-insured home loan

This chapter presents the single–family mortgage insurance program administered by the Department of Housing and Urban Development (HUD) and the Federal Housing Administration (FHA).

Enabling renters to become homeowners

A tenant in an apartment housing complex is solicited by a real estate broker to buy a home. The financial future and tax benefits of home ownership are reviewed with the tenant and compared to the corresponding benefits of rental payments currently paid for shelter by the tenant.

As a result, the tenant indicates he is willing to look into the purchase of a home, but has not accumulated enough cash reserves for the down payment needed to qualify for a purchase-assist loan from a conventional lender, with or without private mortgage insurance (PMI).

However, the broker assures the tenant that first-time homebuyers with little cash available for a down payment can buy a home by qualifying for a *purchase-assist loan* insured by the Federal Housing Administration (FHA).

By insuring loans made with less demanding cash down payment requirements than loans originated by conventional lenders, and with high loan-to-value (LTV) ratios of up to 96.5%, the FHA enables prospective buyers, primarily **renters**, to become homeowners.

For example, when a buyer applies for a conventional loan to finance the purchase of a home, a conventional lender will require a down payment ranging from 10% to 20% of the property's purchase price. Additionally, the loan is often an adjustable rate mortgage (ARM) with rates and payment schedules based on formulas which allow the loan amount to increase from month to month, called *negative amortization*.

Conversely, a typical first-time homebuyer is required to make a minimum down payment of at least 3.5% of the purchase price to qualify for an FHA-insured fixed-rate loan. The interest rate on the loan is negotiated between the buyer and the lender. The FHA does not regulate interest rates, leaving the setting of the interest rate to bond market operations in the secondary mortgage market. [24 Code of Federal Regulations §203.20]

The FHA does not lend money to homebuyers. Rather, the FHA insures loans with up to 30-year amortization periods which are originated by approved *direct endorsement* lenders to qualified buyers to assist them in funding the purchase of a home they will occupy as their principal residence.

One-to-four unit mortgage default insurance

The most commonly used FHA insurance program is the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, Section 203(b).

The purpose of Section 203(b) is to **enable renters to become homeowners** by allowing for a smaller down payment than required for conventional loans from portfolio lenders. For the privilege of making

a **small down payment**, the buyer must pay a mortgage insurance premium (MIP) to FHA of 1.75% of the loan amount on closing and an annual amount of .55% of the loan amount, effectively increasing the annual cost of borrowing as an addition to interest.

Buyers obtaining a Section 203(b) loan must occupy the property as their **primary residence**. Investors are prohibited from using Section 203(b) to purchase property since their intended use of the property would be as a rental, a contradiction of the owner-occupancy purpose of the Section 203(b) program.

Similarly, homeowners with Section 203(b) loans who later sell their home to investors will not receive FHA approval of the sale.

Loan documentation

The following list of documents may be submitted to an FHA–approved Direct Endorsement lender when applying for a loan:

- Uniform Residential Loan Application signed and dated by all buyers and the lender [See **first tuesday** Form 203 (HUD Form 1003)];
- Buyer's Notification and Interest Rate Disclosure Statement signed by both the buyer and the lender [Form HUD-92900-B];
- Credit Analysis Worksheet – LTV and Income Ratios [See **first tuesday** Form 230];
- picture identification and social security number of each buyer;
- Residential Mortgage Credit Report for each buyer;
- verification of employment and most recent pay stub [See **first tuesday** Forms 208 and 208-1];
- verification of deposit and most recent bank statement [See **first tuesday** Form 209];
- federal income tax returns (individual and business) for the past two years for self-employed borrowers [See **first tuesday** Forms 215 and 215-1];
- sales contract containing an amendatory clause, any additional agreements, and the seller's Condition of Property Disclosure – Transfer Disclosure Statement (TDS) [See **first tuesday** Forms 152 and 304];
- verification of payment history of rent payments or mortgages [See **first tuesday** Forms 210 and 210-1];
- Residential Appraisal Report – Detached Single Family Unit or PUD [See **first tuesday** Form 200 (HUD Form 1004)];
- notice to the homeowner regarding possible refunds and MIP; and
- Lead-Based Paint Disclosure signed by the buyer. [See **first tuesday** Form 313]

The public policy rationale behind the Section 203(b) program is based on the proposition that individuals who become homeowners have proven in their later years to be less of a financial burden on the government than the burden imposed by life-time renters. No consideration is given when inducing homeownership to the risks a buyer takes on by the debt burden accompanying an FHA-insured home loan and reduced job mobility during economic downturns.

Under Section 203(b), a loan for the purchase of an **additional residence** will be insured by FHA in the case of hardship to the buyer, such as relocation due to a job. FHA insurance was created to give home sellers the mobility needed to sell and relocate to better jobs. In effect, the mobility of the nation's home-owning work force is not to be hampered for lack of highly leveraged financing. [HUD Mortgagee Handbook 4155.1 Rev-5 Chapter-4 §B.2.d]

FHA loan limits by area

The FHA insures lenders against loss for the full amount of loans made to buyers under the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, a Section 203(b) mortgage. The maximum FHA-insured loan available to assist a buyer in the purchase of one-to-four unit residential property is determined by:

- the type of residential property; and

Acceptable sources of the cash down payment include:

- **Savings and checking accounts:** Lenders must verify the account balance is consistent with the buyer's typical recent balance and no large increase occurred just prior to the loan application.
- **Gift funds:** The donor of the gift must have a clearly defined interest in the buyer and must be approved by the lender. Relatives or employer unions typically are acceptable donors. Gift funds from the seller or broker are unacceptable kickbacks and are considered an inducement to buy and require a reduction in the sale price.
- **Collateralized loans:** Any money borrowed to meet the down payment requirement must be fully secured by the buyer's marketable assets (i.e., cash value of stocks, bonds, or insurance policies), which do not include the home being financed. Cash advances on a credit card, for example, are not acceptable sources for down payment funds.
- **Broker fee:** If the buyer is also a real estate agent involved in the sales transaction, the commission may be part of the buyer's down payment.
- **Exchange of equities:** The buyer can trade personal property he owns to the seller as the down payment. The buyer must produce evidence of value and ownership before the exchange will be approved.
- **Sale of personal property:** Proceeds from the sale of the buyer's personal property can be part of the down payment if the buyer provides reliable estimates of the value of the property sold.
- **Undeposited cash** is an acceptable source of down payment funds if the buyer can explain and verify the accumulation of the funds. [HUD Handbook 4155.1 Rev-5 Ch-5 §B.1]

- the county in which the property is located.

A list of counties and their specific loan ceilings is available from FHA or an FHA direct endorsement lender, or online from the Department of Housing and Urban Development (HUD) at *http://www.hud.gov*.

Loan-to-value (LTV) ceilings

The FHA sets limitations on the amount of a loan it will insure, based on a percentage of the appraised value of the property, called the *loan-to-value (LTV) limitation* or *ratio*.

The **LTV limitations** on an FHA-insurable loan are capped at 96.5%. Thus, the minimum downpayment is 3.5%. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.b]

Additionally, even after including buyer-paid closing costs in the LTV calculations, the insurable loan amount cannot exceed the ceiling of 96.5% of the property's appraised value.

To determine the loan amount the FHA will insure, multiply the appropriate LTV ratio by the lesser of the property's:

- sales price; or
- the appraised value of the property. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.a]

Closing costs may not be used to help meet the 3.5% minimum downpayment requirement. Also, closing costs are not deducted from the sales price before setting the maximum loan amount. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.d]

Such costs include the lender's origination fee, appraisal fees, credit report charges, home inspection fees, recording fees, survey fees and the cost of title insurance.

The lender's origination fee included in the closing costs is limited to 1% of the loan amount, excluding any competitive discount points and the 1.75% upfront MIP.

Veterans applying for an FHA-insured loan are subject to the same LTV limitations applicable to non-veterans.

Either the buyer or seller can pay the buyer's closing costs, called *non-recurring closing costs*. The lender may also advance closing costs on behalf of the buyer.

Discount points or upfront MIPs are not part of the buyer's closing costs since they are considered pre-paid interest. However, when the seller pays the buyer's loan discount points and MIPs, these amounts are then considered *financing concessions.*

Any closing costs or other financing concession paid by the lender or seller in excess of 6% of the property's sales price is considered an *inducement to purchase* and results in a dollar-for-dollar deduction of the excess from the sales price before applying the appropriate LTV ratio. [HUD Handbook 4155.1 Rev-5 Ch-2 §A.3]

The LTV ratio initially sets the loan amount. However, the loan amount cannot exceed the cap of 96.5% of the appraised property value.

For example, a buyer pays $100,000 for a single family residence (SFR) with an appraised value of $100,000. The buyer must pay the minimum down payment of $3,500 in closing costs (3.5%) from his own funds. Thus, the buyer's cost basis for calculating the loan amount is $100,000. The LTV ratio of 96.5% is then applied to the $100,000 cost basis the buyer will have in the property, resulting in a $96,500 maximum loan.

In a seller's market with too many buyers rapidly driving up prices, the price a buyer might agree to pay occasionally exceeds the appraised value of the property. Thus, the gap is widened between the FHA-insurable loan limit and the purchase price. The buyer then has the right to close the transaction by increasing the down payment amount to cover the **higher-than-appraised price** he is still willing and able to pay for the property, an FHA purchase agreement right called an *amendatory clause*. [See **first tuesday** Form 152 §7.7]

Buyers may add the cost of a solar or wind energy system directly to the loan amount before adding MIPs and after applying the LTV ratio limit. The amount a buyer is permitted to add to the loan amount is the lesser of the solar or wind energy system's:

Programs for investors

Despite HUD's general no-investor policy, FHA will insure loans made to investors for these projects:

Mobilehome parks — Finance construction of mobilehome parks consisting of five or more spaces. The park must be located in a HUD approved location where market conditions show a need for this type of housing. [Section 207]

Multifamily rental housing — Finance construction containing at least five units and all must be rented at reasonable prices. [Section 207]

Housing for the elderly — To finance the construction or rehabilitation of housing consisting of at least five units, all of which must be suited to the elderly or handicapped. Convalescent homes are not included in this section. [Section 231]

Nursing homes — To construct or renovate care facilities which accommodate 20 or more patients who require skilled nursing care. Nursing homes, intermediate care facilities, and board and care homes are acceptable types of care facilities. Major equipment needed to operate the facilities can be included in the loan. [Section 232]

Low-income rental assistance — Investors who own housing occupied by low-income tenants can apply for HUD assistance with tenant's rent payments. Under the Section 8 program, HUD makes up the difference between what a low-income tenant can afford to pay and the approved rent for the unit HUD rental assistance subsidies can be obtained for existing housing occupied by tenants whose income is less than 50% of the median income for the area. In addition to rental assistance to property owners, HUD also provides rental vouchers and rental certificates to tenants. [Section 8]

Summary of available HUD/FHA programs

Section 203(b): This is the most commonly used program sponsored by the FHA. Under this section, the FHA insures loans made by Direct Endorsement lenders to creditworthy buyers who will use the home as their primary residence. The maximum loan amount depends on the type of residential property and the county where the property is located. Investors are prohibited from obtaining a loan insured under this section.

Section 203(k): Under this program, the FHA insures loans to finance the rehabilitation of existing homes, the rehabilitation and refinancing of a home, or the simultaneous rehabilitation and purchase of a home. For example, rehabilitation includes repairs, installing solar energy systems, or expanding dwellings. The maximum loan amount is the same as the amount allowed under Section 203(b).

Section 221: Buyers with low and moderate income can apply for a loan insured under this section. The maximum loan limit is considerably less than the limits under Section 203(b). Special terms apply to families who have been displaced by urban renewal.

Section 223(e): Buyers hoping to purchase property which does not meet the requirements under Section 203(b) may apply for a loan insured under this section if the property is in a declining urban neighborhood. The FHA building standards are more flexible than those under other sections and allow purchases in areas where higher standards are unreasonable.

Section 234: This program is similar to Section 203(b) except it insures loans for the purchase of condominiums. The maximum loan limit for an area established by Section 203(b) applies to the purchase of condominiums. Investors who intend to sell individual units may obtain a loan insured under this section.

Section 245: Buyers who anticipate a substantial increase in income may be insured for a graduated payment mortgage (GPM). This allows a buyer to make small monthly payments initially but increase the size of the payments over time. Large down payments are required to prevent the loan amount from exceeding LTV limits. Buyers are subject to all other rules governing HUD insured loans. Five different GPM plans are available and differ in length and the rate of increase.

Section 251: Under the FHA-insured adjustable rate mortgages (ARM) program, the interest rate and monthly payments vary over the life of the loan. The initial rate and payment are negotiable between the buyer and lender. However, the interest rate may only increase or decrease one percentage point in anyone year. Over the life of the loan, the interest rate may not change more than five percentage points. All creditworthy owner-occupants may qualify for an ARM loan.

Section 255: The FHA allows homeowners who are 62 years of age or older to convert the equity in their homes into a monthly income or a stream of credit. This enables homeowners with sizable equity but small income to turn their equity into spendable dollars.

Title 1: Property Improvement loans can be obtained for the repair or improvement of individual homes, apartment buildings, and nonresidential buildings. Loans can also be obtained to finance construction of nonresidential buildings. The maximum loan on single family home improvement is $25,000 and may extend up to 20 years. HUD's Title I program also insures loans to finance the purchase of manufactured homes and lots. The maximum loan amount is: $48,600 for a manufactured home, $16,200 for a lot, or $64,800 for both a manufactured home and a lot. All creditworthy buyers who are owner-occupants are eligible.

- replacement costs; or
- effect on the property's market value. [HUD Handbook 4155.1 Rev-5 Ch-2 §A.5]

Also, the amount added for a solar or wind energy system may exceed the statutory mortgage limit for the area by an additional 20%. [HUD Handbook 4155.1 Rev-5 Ch-2 §A.5.g]

Credit approval

Before FHA will insure a loan, the lender must determine if at least one of the co-applicants is creditworthy. [24 CFR §203.512(b)]

For a buyer to be creditworthy for FHA mortgage insurance, the following debt-to-income ratios must be met:

- the buyer's **mortgage payment** may not exceed 31% of the buyer's gross effective income, called the *mortgage payment ratio*; and
- the buyer's **total fixed payments** may not exceed 43% of the buyer's gross effective income, called the *fixed payment ratio*. [HUD Handbook 4155.1 Rev-5 Ch-4 §F.2]

A buyer's income consists of his salary and wages. Social security, alimony, child support, and government assistance are factored into the buyer's income to determine his *effective income*. The buyer's **effective income** before any reduction for the payment of taxes is called his *gross effective income*.

The maximum **mortgage payment ratio** of 31% of the gross **effective** income determines the maximum amount of principal, interest, taxes and insurance the buyer is able to pay on the mortgage.

Lenders use the maximum **fixed payment ratio** of 43% of the gross effective income to determine whether a buyer can afford to incur the long-term debt of an FHA-insured mortgage in addition to all other long-term payments he must make.

When computing the fixed-payment ratio, the lender adds the buyer's total mortgage payment to all the buyer's recurring obligations (debts extending ten months or more), such as all installment loans, alimony and child support payments, to ascertain the buyer's total monthly fixed payments. [HUD Handbook 4155.1 Rev-5 Ch-4 §C.4]

However, even if the buyer's ratios exceed FHA requirements, the loan may be approved if the buyer:

- makes a large down payment;
- has a good credit history;
- has substantial cash reserves; and
- demonstrates potential for increased earnings due to job training or education, called *compensating factors*. [HUD Handbook 4155.1 Rev-5 Ch-4 §F.3]

Since **predetermined ratios** may not indicate a particular homebuyer's likelihood for default, lenders may be flexible when applying the qualification ratios.

For example, if the buyer's debt-to-income ratios are above the prescribed maximum, the FHA may still insure the loan based on these compensating factors.

Although FHA considers good credit history and a large down payment to be compensating factors, lenders will not fund a loan in practice based on these two factors alone unless the buyer meets the prescribed payment ratios.

Further, race, religion, sex, handicap, familial status, sexual orientation and ethnicity are not compensating factors for evaluating a loan application.

Conversely, a lender cannot deny the loan application of an African-American buyer in an attempt to exclude African-Americans as buyers of homes located in a particular neighborhood. [**Holmes** v. **Bank of America** (1963) 216 CA2d 529]

However, lenders in California can establish loan programs which promote homeownership in ethnic minorities or low-income neighborhoods, provided the programs comply with the federal Fair Housing Act or similar state and federal laws. [Calif. Health and Safety Code §35810]

Due-on-sale clause

Loans insured by the FHA contain a due-on-sale clause which allows the FHA to accelerate the loan if the property is sold in violation of assumability requirements.

The lender of a Section 203(b) loan cannot impose restrictions on the resale of the property or automatically call the loan due-on-sale.

However, to avoid defaults by future owners, when a homeowner with a Section 203(b) loan sells the home, the lender is allowed to approve the sale if:

- one of the new owners is creditworthy;
- the seller retains an ownership interest; or
- the transfer is through a will.

If an FHA-insured property is sold to an unapproved buyer, such as an investor, the lender may request permission from the FHA to accelerate the loan. Only when the FHA approves a call may the lender call the balance of the loan due-on-sale. The FHA has not called any loans under the due-on-sale clause since the policy was initiated in 1985. [24 CFR §203.512]

Investors will not be approved as buyers of property which is subject to a Section 203(b) loan since the property would be a rental and not the investor's primary residence. However, in spite of the FHA's no-investor policy, once an investor purchases a property subject to a Section 203(b)-insured loan, the FHA only requires the investor to make payments as scheduled.

NOTICE OF RIGHT TO RESCIND

Borrower's Right to Cancel

NOTE: This notice only applies when an equity loan or refinance which funds a personal use will be secured by one-to-four unit residential property presently owner-occupied by the Borrower as his principal residence.

FACTS:

1. This notice is given in a loan transaction under an application or loan numbered ____________________________,

1.1 between you ____, as the Borrower, and

1.2 ____, as the Lender,

1.3 in which ____ is the mortgage loan Broker,

1.4 for an amount borrowed of $________________, which is or will be secured by

1.5 property you own located at ____.

NOTICE:

2. You are entering into a transaction which will result in a lien on your home. You have a legal right under federal law to cancel this transaction, without cost, within three business days from whichever of the following events occurs last:

2.1 the date of this transaction which is ______________, 20______;

2.2 the date you received your Truth in Lending disclosures; or

2.3 the date you received this notice of your right to cancel.

3. If you cancel the transaction, the lien is also cancelled.

3.1 Within 20 calendar dates after we receive your notice, we must take steps necessary to reflect the fact that the lien on your home has been cancelled, and we must return to you any money or property you have given to us or anyone else in connection with this transaction.

4. You may keep any money or property we have given you until we have done the things mentioned above, but you must then offer to return the money or property.

4.1 If it is impractical or unfair for you to return the property, you must offer its reasonable value. You may offer to return the property at your home or at the location of the property. Money must be returned to the address below. If we do not take possession of your money or property within 20 calendar days of your offer, you may keep it without further obligation.

How to Cancel:

5. If you decide to cancel this transaction, you may do so by notifying us in writing, at (creditor's name and business address) ____

____

6. You may use any written statement that is signed and dated by you and states your intention to cancel, or you may use this notice by dating and signing the cancellation provision below.

6.1 Keep one copy of this notice because it contains important information about your rights.

7. If you cancel by mail or telegram, you must send this notice no later than midnight of ______________, 20______ (or midnight of the third business day following the latest of the three events listed above at §2).

7.1 If you send or deliver your written notice to cancel some other way, it must be delivered to the above address no later than the time stated above.

Borrower acknowledges receipt of two copies of this notice.

Date: ______________, 20______

Borrower's Signature: ______________________________ Borrower's Signature: ______________________________

Notice of Rescission by Borrower:

I hereby cancel this transaction.

Date: ______________, 20______

Borrower's Name: ________________________________ Signature: ____

Borrower's Name: ________________________________ Signature: ____

FORM 222 06-09

RESPA and TILA disclosures

The Real Estate Settlement Procedures Act (RESPA) requires any lender making an FHA-insured loan to deliver *good faith estimates* of **settlement costs** paid to providers of services on the sale of a one-to-four unit residential property and a Housing and Urban Development (HUD) information booklet within three days after receiving the buyer's application. [See **first tuesday** Form 204 (DRE 883)]

The HUD information booklet contains information about real estate transactions, settlement services and consumer protection laws. [24 CFR §3500.6 (a)(3)]

Upon closing a sale, an escrow agent handling the loan must deliver to the buyer and seller a HUD-1 closing statement detailing all loan related charges incurred by the buyer and seller. [24 CFR §3500 et seq.; see **first tuesday** Form 402 (HUD-1)]

Further, the *Truth-in-Lending Act* (TILA), referred to as *Regulation Z*, requires lenders making loans for *personal use* (i.e., the purchase of a personal residence) to disclose details about the **loan terms**, such as the amount funded, direct loan costs, payment schedules, the loan's annual percentage rate (APR), and the interest rate. [See **first tuesday** Form 221]

Loans insured by the FHA under section 203 (b) are subject to both disclosure requirements since they fund personal use loans (TILA) and are federally related loans (RESPA). Thus, RESPA and TILA disclosures on FHA-insured loans are delivered together by the lender within three business days after receiving the buyer's loan application. [12 CFR §226.19]

If the lender adjusts the annual percentage rate (APR) by more than 1/8 (one eighth) of 1% from the rate initially offered after receiving the buyer's loan application, the lender must **redisclose** the new adjusted APR before the buyer signs the loan documents. [12 CFR §226.19(a)(2)]

Lenders are not required to give the three-day right of rescission to buyers obtaining an FHA-insured home loan under the owner-occupied, one-to-four family home mortgage insurance program, Section 203(b), since the right to rescind does not apply to purchase-assist financing of **residential sales,** only to personal-use equity loans secured by any type of property. [12 CFR §226.23(f)(1); see Form 222 accompanying this chapter]

Editor's note — In practice, lenders of residential purchase-assist loans generally give the right of rescission, although they are not obligated to do so. If given the right to rescind by the lender, the buyer may rescind the loan transaction up to three days after signing the loan documents. [12 CFR §226.23]

Before closing, lenders must also hand buyers a prepayment disclosure statement informing buyers they can prepay any or all of the remaining balance of the loan without a **prepayment penalty** on any installment due date. [24 CFR §§203.22(b), 203.558(a)]

The prepayment of loans insured by the FHA should be made on a regular installment due date, since some lenders charge interest on the amount owed through the end of the month if the loan is prepaid during the month between due dates.

Personal liability

When an owner sells his property subject to an existing FHA-insured loan and the buyer takes over the loan, the seller will be released from personal liability for that loan, if:

- he requests a release from personal liability;
- the prospective buyer of the property is creditworthy;
- the prospective buyer assumes the loan; and
- the lender releases the seller from personal liability by use of an FHA-approved form. [HUD Form 92210; 24 CFR §203.510(a); HUD Handbook 4155.1 Rev-5 Ch-7]

If the conditions for release from personal liability are satisfied, but the seller does not **request a release**, he remains liable to the FHA for any default occurring within five years after the sale. [12 USC §1709(r); see Chapter 23]

However, if five years pass from the time the property is resold, the seller is released from personal liability if:

- the buyer assumes the loan with the lender;
- the loan is not in default by the end of the five-year period; and
- the seller requests the release of liability from the lender. [24 CFR §203.510(b)]

Lenders must inform borrowers of the procedure for obtaining the release from personal liability on resale when the loan is originated. [24 CFR §203.510(c)]

Buyer liability on a default

If a buyer defaults on an FHA-insured loan, the FHA covers the lender against loss on the entire remaining balance of the loan, unlike PMI and insurance from the Veterans Administration (VA) which only insures a portion of the total loan amount.

After the lender acquires the property through foreclosure and conveys the property to the FHA, the FHA pays the lender the amount of the remaining original principal on the loan at the time of foreclosure of a property insured by the FHA. If a bidder other than the lender acquires the property at the foreclosure sale, the FHA pays the lender the amount of the unpaid principal balance, minus any amounts the lender receives from the bidder. [24 CFR §203.401]

Before accepting a conveyance from the lender, the FHA requires the lender to confirm the property is in a marketable condition and has not suffered any waste. The FHA then sells the property to recoup the amount it paid to the lender.

Unlike conventional home loans where only a lender is involved, a homebuyer who takes out an FHA-insured loan with a lender is personally liable to the FHA under the mortgage insurance program for any loss the FHA suffers as a result of the homebuyer's default. When the FHA suffers a loss, the FHA can

obtain a money judgment against the homebuyer for the difference between the amount the FHA paid the lender and the price received from the sale of the property. California anti-deficiency mortgage laws do not apply to FHA-insured loans. [24 CFR §203.369]

Chapter 40 — Private mortgage insurance

This chapter presents the availability of private insurance (PMI) on high loan-to-value mortgages for the purpose of covering lender losses on a default by the borrower.

Covering lender losses on default

Consider a prospective homeowner who wants to purchase a detached single family residence (SFR) which he intends to occupy as his principal residence. The property is not located within a common interest development (CID), such as a development managed by a homeowners association (HOA). The terms for payment of the price will be a 10% down payment from funds held by the buyer.

The balance of the price will be funded by a conventional fixed-rate purchase-assist loan (FRM) which will not exceed $417,000. Rebates received by the buyer, whether funded directly or indirectly by the seller from the proceeds of the sale or by the broker from the seller-paid broker fees, will not exceed 3% of the price paid for the property.

The buyer is referred to a mortgage lender to arrange for the origination of a conventional loan on an application from the buyer. Thus, the loan will not be guaranteed by the Federal Housing Administration (FHA) or Veterans Administration (VA).

However, the loan will fund 90% of the property's value, a **loan-to-value ratio** (LTV) which exceeds the margin generally considered free from risk of loss should the buyer default. To shift that risk of loss to others, the lender requires private mortgage insurance (PMI). The lender's alternative would be to retain the risk and attempt to cover it with an increase in the rate of interest when the loan amount exceeds 75% to 80% of the property's value.

A mortgage lender may require any borrower to qualify and pay the premium for PMI as a condition for making a trust deed loan. [Calif. Civil Code §2954.6]

Most prudent lenders originating loans for owner-occupant buyers of residential real estate whose down payment is less than 20% of the purchase price will insist the loan be insured by PMI to cover the risk of loss on a default by the buyer.

Thus, a real estate agent involved in a sale, the closing of which is contingent on new conventional financing with an LTV ratio exceeding 80%, will retain control of the transaction's destiny and avoid surprises based on his knowledge of four sets of considerations used by issuers of PMI:

1. The buyer's profile
2. The property purchased
3. Loan terms and conditions
4. Loan processing package

List of authorized California mortgage insurers

- Mortgage Guaranty Insurance Corp.
- MGIC Credit Assurance Corp.
- CMG Mortgage Insurance Co.
- Genworth Residential Mortgage Insurance Corp. of North Carolina
- Genworth Mortgage Insurance Corp.
- Radian Guaranty Inc.
- PMI Mortgage Ins. Co.
- Amerin Guaranty Corp.
- United Guaranty Residential Insurance Co.
- United Guaranty Mortgage Indemnity Co.
- Republic Mortgage Insurance
- Triad Guaranty Insurance Corp.

Protecting the lender from loss

Private mortgage insurance (PMI) indemnifies a lender for financial loss on a loan secured by an interest in real estate when a **borrower defaults**. [Calif. Insurance Code §12640.02]

The lender's recoverable losses include principal on the debt, any deficiency in the value of the secured property, and foreclosure costs, but exclude losses due to flood, earthquake or fire damage, which are separately insurable.

Also, PMI is not mortgage life insurance. Mortgage life insurance pays off the insured loan in the event a borrower dies, becomes disabled, or loses his health or income.

Private mortgage insurers are unrelated to government-created insurance agencies, such as the Federal Housing Administration (FHA) and the Veterans Administration (VA), which also insure or guarantee loans made to qualified trust deed borrowers. [See Chapter 39]

Loans insured by the FHA, VA, and the California Department of Housing and Community Development (HCD) have their own guidelines and are not subject to laws controlling PMI.

Private mortgage insurance coverage

Private mortgage insurance (PMI) insures a percentage of a real estate loan. In turn, the loan amount represents a percentage of the property's value, called the *loan-to-value ratio* (LTV).

Typically, loans insured by PMI, including fixed-rate mortgages (FRMs) and adjustable rate loans (ARMs) for purchase-assist or refinancing, are covered for losses on loan amounts exceeding 67% of the property's value at the time the loan is originated.

The buyer usually pays the PMI premiums, not the lender, although the lender is the insured and holder of the policy.

However, some lenders and PMI carriers offer a Lender-Paid Mortgage Insurance (LPMI) program. If issued by the PMI carrier, the lender will pay the mortgage insurance premium (in a lump sum or on a monthly basis) and in turn charge the borrower a higher interest rate on his principal payments.

Premium rates are set as a percentage of the loan balance and are calculated in the same manner as interest.

When the buyer qualifies for PMI and a policy is issued, the lender must notify the buyer at the time of closing and each year thereafter of the buyer's right to cancel the PMI.

Later, if the buyer is current on his PMI payments and has taken out no other loans on his property, he may request the termination of his PMI when the equity in his property reaches 20% of its value at the time the loan was originated. PMI will be canceled automatically once the buyer reaches 22% equity in his property (unless the loan is a piggyback 80-10-10 loan).

Furthermore, the buyer may cancel his PMI two years after the loan is recorded. However, the buyer may not cancel his PMI until the LTV for the loan balance is 75%, unless the lender has agreed to a higher LTV. Also, if monthly installments on the note during the year prior to the request for cancellation are more than 30 days overdue, or if the buyer has other liens on the property, the lender or private insurer will not terminate the PMI. [Calif. Civil Code §2954.7]

If cancellation of PMI is permissible, the lender under the note may not charge advance PMI payments unless the borrower has incurred more than one late penalty in the past 12 months, or has been more than 30 days late on one or more payments on the note. [Calif. Civil Code §2954.12]

Premiums charged by PMI insurers do not include an up-front fee on origination, only an annual fee calculated as a percentage of the loan balance. During the first half of 2009, the annual PMI rate was .6% of the loan balance, payable monthly, an amount which is added to the principal and interest payments on the loan. In contrast to FHA mortgage insurance premiums (MIP), FHA charges an up-front fee of 1.75% of the loan amount; the FHA annual charge is .55% of the loan balance payable monthly in addition to the principal and interest payments.

During the same period in 2009, interest rates for conventional loans under PMI and FHA insured loans were very different: 30-year fixed rate conventional loans had an average west coast rate of 4.9%; 30-year fixed rate FHA loans had an average west coast rate of 5.6%.

Thus, the monthly combined percentage rate paid on a PMI conventional loan was 5.16%, while the combined rate for an FHA insured loan was 6.15% (plus the 1.75%-of-loan up-front MIP fee). The primary reason for the cost difference is the risk of loss with the 3.5% down for FHA versus the risk with the 10% down for PMI coverage.

California PMI circa 2009: distressed

PMI insurers have labeled five states and numerous metropolitan area across the USA as *distressed areas*. Coupled with the distressed area label are severe limitations on the class of buyer, type of property and terms of a loan which qualify the lender for PMI coverage.

The entire state of California has been classified as distressed for PMI purposes (2009). How many months or years this classification as a distressed area will remain with California will only be known when the real estate market stabilizes and demonstrates property values will not drop further and job losses have ended.

For now, the time for reclassifying California as other than a distressed area appears to be well off into 2012, or 2013 and beyond. However, as foreclosures abate to below 50,000 trustee's sales during any twelve-month period (a foreclosure figure still too high for a normal lender environment or a return to PMI underwriting standards existing prior to the mid-2000 boom years), PMI insurers will know the extent of their present and future losses. They will then be able to neutralize the now stringent parameters for issuing PMI coverage in California.

Further, competition among presently decimated PMI carriers, who will by then have recapitalized by retaining profits and issuing stock, will force the relaxation of underwriting principles which now exclude most properties, buyers, loans, and loan packaging procedures. The FHA has temporarily filled the gap on low-priced properties.

The leveraged buyer and PMI

The individual or couple looking for housing to own and occupy as their primary residence must first compile cash or cash equivalence for a **downpayment** in an amount greater than 20% of the price of the housing they want for shelter. If not, they must be able to qualify and pay for the cost of **default insurance**, called *mortgage insurance*.

If they have accumulated cash for a downpayment of 10% or more, they may be able to qualify for private mortgage insurance (PMI). Thus, they will avoid the more lenient yet more expensive government insured mortgage plans (interest and premiums) available for homebuyers with less than 10% cash accumulated for a downpayment.

The lender making a conventional loan to fund the purchase of a principal residence when the loan will exceed 80% of the property value will require the buyer to meet the qualifications for PMI coverage, not just the lender's qualification requirements. Thus, PMI qualification requirements become the lender's minimum requirements for making the loan.

In California as a *distressed area* for issuance of PMI coverage, the buyer must meet the following standards:

- a minimum credit score of 720 (out of 800) with no exceptions and at least three trade lines supporting the credit score;
- a debts-to-income ratio of no more than 41%;
- two months PITI payments in cash reserves on closing is waived;
- employment full time during the past two years, a current pay stub, written verification by employer (VOE form), and telephone confirmation of employment at closing, unless self-employed;
- if self-employed, financial statements for two prior years and year-to-date, IRS tax returns;
- legal residence in the USA;
- all documents and title vestings to be in the name of the buyer as an individual, as no entities or alternative vestings qualify;
- limit to three loans under PMI coverage in name of buyer;
- completion of a homeowners course of education on mortgage debt obligations;
- no bankruptcy within four years, unless excused by extenuating circumstances in which case the penalty box for ostracizing the buyer (even though otherwise fully qualified) is two years; and

- no prior foreclosure under a mortgage, ever.

Pre-approval letters from a lender will likely be limited to a credit score investigation and, if self-employed, a review of employment or financial statements to workup the debts-to-income (DTI) ratios. The PMI full *documentation efficiency* investigation will take place after submission of a loan application and, as usual, will essentially be limited to verification of all the buyer's representations on the application.

PMI's type of property

The availability of PMI coverage for different types of California real estate is now (2009) severely limited. This condition for coverage will remain until the real estate market is no longer stressed with the prospect of declining property values. Only properties classified as single family residences (SFRs) are now provided with PMI.

Also, SFRs are further categorized as either detached or condos, the distinction reflected in the amount of downpayment required for PMI. Thus, the property type drives the downpayment amount needed before the lender will make a loan on purchases with less than a 20% downpayment.

For California **property to qualify** for PMI coverage, the property must meet the following standards:

- use of the property to be as the principal residence of the buyer on closing;
- vesting of title to the property to be in the name of the individual(s) purchasing the property;
- ownership is not to be for investment (no two-to-four units), no second home or vacation-rental property, and no manufactured housing;

Submitting PMI claim

Consider a lender whose loan is secured by a first trust deed on a personal residence in default.

The lender forecloses on the property by a trustee's sale and acquires the property by bidding the dollar amount of its current fair market value (FMV). The lender then submits its claim to the insurer, including documents showing the price bid at the trustee's sale and a recent appraisal of the property.

If the owner of the property is in default, and the insured lender is willing to work out a short sale, the PMI carrier must be notified immediately of the impending short payoff. PMI will not cover loan discounts on short sales unless the owner is **in default**.

Additionally, PMI policies contain a physical damage exclusion which provides that PMI the carrier can require any damage to the secured property totaling more than $1,500 be repaired before the carrier will pay the lender's claim.

In the event the improvements are totally destroyed due to a catastrophe such as a fire or an earthquake, the PMI carrier is not obligated to pay the lender on a default until the improvements and the lender's LTV prior to the damage have been restored.

- detached SFR property not located within a common interest development (CID/HOA) to be acquired with a minimum 10% downpayment (up to 19%), with a rebate from the seller and brokers limited to 3% of the purchase price for non-recurring closing costs;

- SFR units within a condominium common interest development (CID) which is subject to a homeowners association (HOA) to be acquired with a minimum 15% downpayment (up to 19%), if the HOA meets the following standards:

- cash reserves of amount equal to not less than three months of assessments;

- 10% of assessments have been reserved monthly for capital expenditures and maintenance over the past 12 months;

- maximum of 30% rental of units within the CID;

- maximum of 15% foreclosures within the CID; and

- maximum of 10% ownership of units by any one person.

Thus, investors and speculators are not welcomed; only buyer-occupants of SFRs need apply for PMI, until the competition among PMI insurers heats up, lenders start pushing the PMI insurers around (again) or the market returns to allow the PMI insurer a profit, a restructured capitalization and a firm grip on the rate of losses from foreclosures. The light at the end of that tunnel has not yet come into view (2009).

However, investors acquiring SFR property with the intent to hold long term for income production must be allowed into the PMI market as they benefit families who rent. As for speculators, the hit-and-run flipping-property crowd, neither PMI, FHA, lender nor broker should deal with them. Speculators remove property from the marketplace (not for sale or for rent) only to return it after their activity has driven up the price of property. Not a good thing for stability in any marketplace, and a destructive non-productive allocation of national resources.

Qualifying the loan for PMI

Current economic forces have narrowed the classification of loans PMI insurers will cover based on the likelihood of a foreclosure within different types of loans. Loans favored by PMI insurers include fixed-rate notes (FRMs) for amounts less than 90% of the property value (LTV) which fund the purchase of a detached SFR acquired by a buyer who intends to occupy it as his principal residence. All other loans are disfavored, and are avoided by imposing more stringent requirements to qualify for PMI or refusing them coverage since they present risks insurers are no longer willing to accept for any amount of premium.

For a loan to qualify for PMI, its terms and conditions must include:

- funding of a purchase-assist acquisition of a principal residence by a buyer;

- maximum loan amount of $417,000, as no jumbo loans will be insured;

- a 90% LTV for a detached SFR not located within a CID/HOA;

- an 85% LTV for a unit located within a CID/HOA;

Making PMI Available

Many mortgage bankers and mortgage lenders offer their own mortgage insurance programs.

These private mortgage insurance (PMI) programs tend to have lower underwriting standards and espouse a goal of encouraging less creditworthy, lower income buyers to take part in the "American Dream" of homeownership.

Insurance companies that offer or specialize in mortgage insurance responded to the 1990s crunch by covering loans with 97% loan-to-value ratio (LTVs).

In addition to lowering loan qualification standards, some mortgage bankers and lenders pool PMI-warehoused loans for bidding by private mortgage insurers. Pooling loans allows the mortgage lender to negotiate a better rate and reduce mortgage insurance underwriting requirements.

For example, a borrower is offered an insurance rate on his loan by the mortgage lender. The lender pools together 100 qualified loans and accepts bids from mortgage insurers for the lowest rate. The new lowest rate is passed on to the borrower.

The goal of loosening standards and the practice of pooling loans is to increase consumership when sales and lending suffer from a decline in loan and policy originations.

This is good news for real estate brokers trying to sell in a buyer's market. When buyers are leery of investing in real estate due to a weak market, or when renters want to buy are not quite qualified, PMI makes the purchase of a home increasingly available by reducing the lender's risk of loss on a default.

- maximum 40 year amortization schedule, as no interest-only or option payment loans are insurable;
- fixed rate loans; and
- adjustable rate loans if the rate is fixed for the first five years and on the rollover into an ARM they have no possibility of negative amortization.

Loan packaging for PMI document efficiency

Full documentation in the loan packaging process is fundamental to a lender controlling his risk of loss on each loan he originates. However, during the virtuous cycle of a real estate boom, lenders, PMI insurers, wall street bankers bundling and securitizing loans, government regulators, legislators and builders deliberately relax lending guidelines and standards to let the market rise continue. No one wants to be seen as stopping the party.

Pushed by expediency to close loans during boom times, investigations into credit, source of downpayment funds, verification of loan application representations, restricted interested-party involvement and underwriting review requirements are intentionally reduced, and in some cases eliminated entirely – again to get in on the action. It is in this environment that "no-doc" loans are produced, the antithesis of *document efficiency.*

Fundamentals of mortgage lending call for full documentation, analysis of credit and income, and a review of the completed package by the lender who will end up actually owning the loan and taking the risk.

Selling agents, and of course listing agents, whose clients are most affected by a need for PMI, tend to view loan packaging – including the loan application – as a mysterious activity. Most *transaction agents* – those working a sale as a listing or selling agent – are ignorant of the multiple stages and steps taken to process an application and eventually fund a loan. This lack of knowledge is a disservice to all involved in the sale that is contingent on financing.

A knowledgeable **transaction agent** can and should be able to pre-determine the likelihood of his closing a sale which is contingent on a purchase-assist loan by conducting his own review of a buyer's credit score and source of funds. Only then is he ready to commence the search for suitable property on behalf of a buyer or enter into purchase agreement negotiations with a prospective buyer.

The **loan packaging process** demanded of lenders by PMI insurers includes:

- verification of every material representation of the buyer in the loan application, called *document efficiency* [See **first tuesday** Form 207 through 213];
- acquisition of third party reports, such as the buyer's credit score and appraisal of property value;
- analyzation of the buyer's total debt payments as a percentage of gross income, called the DTI ratio; and
- review of all documents gathered during the due diligence investigation into the loan application representations.

PMI will no longer insure a loan packaged by a mortgage loan broker; only institutional lender packaging is acceptable.

Defaulting borrower and PMI recourse

Most private mortgage insurance (PMI) contracts do not authorize the carrier to seek **indemnity** from the borrower for claims made on the policy by the lender — unlike Federal Housing Administration (FHA) or Veterans Administration (VA) insurance programs which place homeowners at a risk of loss for a greater amount than their down payment.

However, if the loan is recourse such as refinancing, the lender's right to seek a deficiency judgment may be assigned to the PMI carrier. Pursuing a money judgment for a deficiency in the value of the property requires a judicial foreclosure action in lieu of a trustee's foreclosure sale.

However, most insured loans are *purchase-money loans* made to buyer-occupants to acquire their principal residence. Purchase money loans are **nonrecourse obligations**, with recovery on the loan limited to the value of the real estate. [Calif. Code of Civil Procedure §580b]

In the case of fraud on recourse or nonrecourse loans, the PMI carrier is not barred by anti-deficiency statutes and will be able to enforce collection of his losses against the borrower for misrepresentations, such as the property value.

The PMI credit check

To qualify for PMI, the buyer must:

- be a natural person, not a corporation, partnership or limited liability company; and
- take title as the vested owner of the property.

The lender, when qualifying the buyer for a loan to be covered by PMI, relies on the more restrictive PMI insurer's requirements regarding the buyer's:

- liquid assets after closing;
- debt-to-asset ratio;
- debt-to-income ratio; and
- regard for financial obligations.

A buyer required to qualify for PMI before a lender will fund a loan undergoes an in-depth risk analysis based on the PMI carrier's eligibility requirements.

Lenders often turn down applications for loans due to the buyer's inability to qualify for PMI. At a minimum, the buyer will be required to submit documents for review by the PMI insurer, including:

- a copy of the loan application;
- a credit report current within 90 days and covering a minimum of two years; and
- an appraisal of the real estate to be purchased.

However, the PMI carrier may also require additional documentation to verify the loan transaction fulfills the insurer's underwriting requirements, including:

- verification the buyer will occupy the property;
- verification the land value of the property does not exceed 40% of the total value of the property;
- a copy of the signed purchase agreement/sales contract;

- verification of funds for closing;
- verification of the buyer's salary/wages, including overtime and second jobs; and
- verification of employment.

The buyer's credit rating and disposable income must clearly support his ability to make the monthly payments on the low down payment loan.

Chapter 41 — Usury and the private lender

This chapter explains the private lender's exemption from usury limitations when the loan is arranged by using a licensed real estate broker.

Broker arranged loans avoid usury

When a loan is made, the lender charges the borrower **interest** for use of the money during the period lent. However, the amount of interest a private, non-exempt lender can charge is regulated by statute and the California Constitution, called *usury laws*. [Calif. Constitution, Article XV; Calif. Civil Code §§1916-1 through 1916-5]

Today, the remaining goal of usury laws is the prevention of **loan-sharking** by private lenders — charging interest at a higher rate than the ceiling-rate established by the usury laws, a *threshold rate of interest* beyond which the non-exempt loan becomes categorized as *usurious*. [CC §1916-3(b)]

Usury exemptions spur competition

Adopted in 1918 as a consumer protection referendum, the first California usury laws set the maximum interest rate at 12% for **all lenders**; no exceptions.

During the Depression, legislators noted the adverse effect the ceiling-rate restriction on interest rates money lenders could charge was having on the money supply and the economy.

So, in 1934, usury laws were constitutionally amended in a trade off — lowering the maximum rate to 10% while exempting several classes of significant lenders entirely.

Lenders such as savings and loan associations (S&Ls), state and national banks, industrial loan companies, credit unions, pawnbrokers, agricultural cooperatives and personal property brokers could lend at whatever rate the market would bear without fear of penalty *by forfeiture of interest earnings*.

Exemptions successfully opened the market by increasing the availability of funds. In turn, interest rates were driven lower due to increased competition.

When money grew tight again in the late 1970s, legislators applied the same strategy to loosen up what had by then become massive amounts of funds held by individuals in savings accounts by initiating a proposition in 1979.

On passage of the 1979 initiative, real estate loans **made or arranged** by real estate brokers were added to the list of usury-exempt lender situations. [Cal. Const. Art. XV]

The 1979 law also gave the legislature the power to exempt other classes of lenders from usury limits. The legislature has since exempted corporate insurance companies and consumer finance lenders, but not CalPers.

Interest paid with goods and services

When a borrower pays interest on a loan, he is really paying rent to the lender for use of his money for a period of time. The money lent is fully repaid during or at the end of the period.

Normally, the amount of interest charged is a fixed or adjustable percentage of the amount of money loaned.

Though interest is commonly paid with money, interest may also be paid with personal property or services. The many **types of consideration** given for making a loan become part of the lender's yield on the loan—interest. [CC §1916-2]

Thus, interest includes the value of all compensation a lender receives for lending money, whatever its form, excluding reimbursement or payment for loan origination costs incurred and services rendered by the lender. [CC §1915]

However, it is common for **non-exempt private lenders** to attempt to evade the usury law restrictions on interest and the payment of taxes by including bogus charges or claiming fees—points for their making the loan.

Any lender can charge the borrower a bonus, commission or discount, or receive services or goods from the borrower. However, charges and receipts are considered interest only when they do not compensate or reimburse the lender for services rendered in the process of originating the loan.

Charges unrelated to loan origination services are added to the interest stated in the note to determine the aggregate yield on the principal. The average annual yield over the life of the loan may not exceed the *threshold rate* which triggers application of the usury laws — unless the loan transaction is exempt. [**Haines** v. **Commercial Mortgage Co.** (1927) 200 C 609]

As long as the service performed or the expense incurred was necessary to the origination of the loan, the charges do not add to the lender's yield and is not considered interest. [**Klett** v. **Security Acceptance Co.** (1952) 38 C2d 770]

Examples of services and expenses not included in the interest yield include:

- appraisal, escrow and recording fees [**Ex Parte Fuller** (1940) 15 C2d 425];
- negotiation and brokerage fees paid to a third party [Ex Parte Fuller, *supra*];
- administrative costs, such as foreclosing on the defaulted loan or reconveyancing [**Penziner** v. **West American Finance Company** (1937) 10 C2d 160];
- attorney fees for legal services relating to the loan, such as preparation or review of loan documents [**Murphy** v. **Wilson** (1957) 153 CA2d 132]; and
- late charges due on loan default or prepayment penalties. [**First American Title Insurance & Trust Co.** v. **Cook** (1970) 12 CA3d 592]

Setting the interest rate

If the proceeds of a loan, including *home equity loans* funded by a non-exempt lender, are earmarked primarily for **personal, family, or household use** by the borrower, then the maximum annual interest rate is 10% per annum, whether secured or unsecured. [Calif. Const. Art. XV §1(1)]

However, loans made to fund the improvement, construction, or **purchase of real estate** when originated by a non-exempt private lender are subject to a different usury threshold rate, which is the greater of:

Determining the Federal Discount Rate

The discount rate set periodically by the Federal Reserve Bank of San Francisco (FRBSF) is the rate the "fed" charges member banks on advances of funds – money lent by the fed.

The discount rate is reviewed no less than once every fourteen days by the Board of Directors of the Federal Reserve Bank of San Francisco. A review can bring a change in the discount rate – depending on how the directors view the economic health of the region, nation and world. For monthly updates of the Discount Rate, see the **first tuesday** Rate Page at http://blog.firsttuesdayjournal.com.

The maximum interest rate allowable beyond the 10% minimum threshold rate for usury limitations is calculated and set for each month. The usury threshold rate set for a particular month applies to only those loan transactions entered into any time during that month, a fixed rate attached to that loan for the life of the loan.

The Federal Reserve discount rate used to calculate the usury threshold rate for loans agreed to during a particular month is the San Francisco Federal Bank rate for the 25th day of the previous month.

A loan transaction falls within a particular month based on the date of the earlier of:

- entering into the agreement to make the loan; or
- the funding of the loan if no prior agreement has been entered into for the non-exempt lender.

For example, a private lender signs loan escrow instructions on April 22, agreeing to fund the loan in two weeks, closing in the month of May. The lender is not a party to any prior loan agreement. The borrower's loan application was received by the mortgage loan broker (MLB) in the prior month of March.

The Federal Reserve discount rate applicable to April is 7%, April being the month the loan escrow instructions (or other loan agreement) were signed – entered into – by all parties.

The interest rate agreed to is 12% -- the maximum yield permitted without triggering the usury threshold rate controlling non-exempt private lenders who make real estate loans entered into in the month of April (7% plus 5%).

However, on April 25th, the Federal Reserve discount rate is 6%, not the 7% it was on the 25th of March. Thus, the FRBSF rate applicable for the month of May is 6%.

Prior to closing in May, the borrower claims his loan interest rate should fall to 11% to reflect the change, because the 12% agreed to in the loan is a usurious yield for loans funded during the month.

However, 7% was the Federal Reserve discount rate in effect on the 25th day of April, the month during which the lender first committed – by signing the loan escrow instructions or other agreement – to make the loan.

Since the commitment to make the loan occurred earlier than the funding, the rate for the month in which the lender's commitment occurred controls – even though the loan was funded in a following month with a different, lower rate for loan commitments made during that month.

Editor's note – Contingent interest, such as increased interest received on an adjustable rate loan (ARM), is not subject to usury limitations, unless the ARM contained a note rate in excess of usury limitations when originated, or the ARM was designed with an intent to evade usury laws [McConnell v. Merrill Lynch, Pierce, Fenner & Smith, inc. (1978) 21 C3d 365]

- 10% per annum; or

- the applicable discount rate of the Federal Reserve Bank of San Francisco (FRBSF), plus 5%.

Usury law and real estate loans

Two basic classifications of private loan transactions exist relating to interest rates private lenders may charge on real estate loans:

- **brokered** real estate loans; and

- **restricted** or **non-brokered** real estate loans.

Brokered real estate loans are exempt from usury restrictions and fall into one of two categories:

- loans **made** by a licensed real estate broker **acting as a principal** for his own account as the private lender who funds the loan; or

- loans **arranged** with private lenders by a licensed real estate broker acting **as an agent** in the loan transaction for compensation.

Restricted real estate loans are all loans made by private party lenders which are neither made nor arranged by a broker.

Editor's note — Private lenders include corporations, limited liability companies and partnerships. These entities would not be exempt from usury limitations unless operating under an exempt classification, such as a personal property broker or real estate broker.

The most common restricted loan involves private party lenders, unlicensed and unassisted by brokers, who make secured or unsecured loans.

For example, a borrower contacts a private lender for a loan. The individual lending the money is a licensed **California real estate broker**. The lender advances the loan funds and the borrower executes a note in favor of the lender, secured by a trust deed on real estate owned by the borrower. The rate of interest called for in the note exceeds the usury threshold.

The borrower timely repays the note and the lender reconveys the trust deed. The borrower then makes a demand on the lender to return all interest paid, claiming the loan was a usurious transaction. The lender rejects the interest refund demand, claiming he is a licensed real estate broker and loans made by him from his own funds as a principal are exempt from usury laws.

Is the borrower entitled to a refund of the interest paid?

No! The loan was made by a person who was a licensed California real estate broker when the loan was originated. Thus, the loan is exempt from usury limitations. [**Garcia** v. **Wetzel** (1984) 159 CA3d 1093]

Although loans made or arranged by brokers are exempt from usury limitations, loans made by an unlicensed private lender to a borrower who is a licensed real estate broker are not exempt, unless a third party who is a licensed broker arranged the loan. [**Stoneridge Parkway Partners, LLC** v. **MW Housing Partners III L.P.** (2007) 153 CA4th 1373]

Exceptions for private parties

Private party transactions involving the creation of a *debt* which avoid usury laws break down into two categories:

- **exempt debts**, being *debts* which involve a loan or a forbearance on a loan and are broker made or arranged; and

- **excluded debts**, being *debts* which do not involve a loan.

The most familiar of the excluded "non-loan" type debts is the seller carryback.

Carryback notes executed by the buyer in favor of the seller of any real estate, secured or unsecured by the property sold or other property, are not loans of money; they are credit sales, also called installment sales.

As the debt credited in a credit sale, the seller carries back a note, secured or unsecured, at an interest rate which may permissibly be in excess of the usury threshold rate. The rate exceeding the usury law threshold is enforceable since the debt is not a loan. Thus, the carryback note is not subject to usury laws. [See Chapter 42]

Penalties for usury

The most common **penalty** suffered by a non-exempt private lender is the forfeiture of **all interest** for the loan. Thus, the lender is only entitled to a return of the principal advanced on the loan. [**Bayne** v. **Jolley** (1964) 227 CA2d 630]

The lender may also have to pay a usury penalty of treble damages. [CC §1916-3]

Treble damages are computed at three times the **total interest paid** by the borrower during the one year period immediately preceding his filing of a suit and the period of litigation until the judgment is awarded.

An award of treble damages as a penalty is normally reserved for a lender the court believes took *grossly unfair advantage* of an unwary borrower. [**White** v. **Seitzman** (1964) 230 CA2d 756]

A borrower who knew at all times a loan interest rate was usurious is not likely to be awarded treble damages. Also, a lender who sets a usurious rate in complete ignorance of the illegality of usury would not be additionally penalized with treble damages.

Usurious loans to a broker/borrower

Consider an owner of real estate who is a licensed real estate broker and negotiates directly with a private lender to obtain a loan secured by his property.

The interest charged for the loan exceeds the usury threshold rate. The loan is negotiated without the services of another real estate broker arranging the loan.

The lender funds the loan escrow. The trust deed is recorded and the note is delivered to the lender. The borrower is handed the net loan proceeds on closing.

When the note becomes due, the owner/broker tenders payment of an amount equal only to the principal advanced by the lender and demands a reconveyance. The owner claims he owes only the principal borrowed and no interest, since the interest rate is usurious.

The private lender claims the loan transaction is exempt from the interest restrictions of California's usury laws since the borrower is a licensed real estate broker.

Is this loan controlled by usury laws if the owner who borrowed the money is a licensed real estate broker?

Yes! The private lender's rate of return on the loan is limited by usury laws, unless;

- the private lender who **made the loan** is a licensed real estate broker; or

- a real estate broker is paid to **arrange the loan** as an agent of at least one of the parties to the loan. [**Winnett** v. **Roberts** (1986) 179 CA3d 909]

Attorneys as brokers

Although attorneys are authorized to perform brokerage activities for compensation in the normal course of the practice of law, an attorney's activities in arranging a loan are not covered by the broker's usury exemption.

For example, a borrower retains an attorney, who is also a licensed real estate broker, to arrange a loan from an unlicensed private lender to be secured by real estate owned by the borrower.

Between the time the attorney/broker is retained by the borrower and the time the loan is arranged, the broker's license held by the attorney expires. The loan transaction closes before the attorney renews his broker's license. The note is payable in monthly installments of interest only, principal being payable as a final/balloon payment on the due date.

After making several interest payments, the borrower defaults and the lender begins foreclosure.

The borrower claims the loan has a usurious rate of interest and is controlled by usury laws since the attorney arranging the loan did not have a valid broker's license on the date the lender committed in writing to make the loan. The lender claims the loan is exempt from usury laws since the attorney is authorized to conduct, for compensation, all activities requiring a broker's license without first obtaining a broker's license.

Can the borrower totally avoid the payment of interest on the attorney-negotiated loan?

Yes! While attorneys may perform acts requiring a broker's license so long as they are rendered in the course of the practice of law, attorneys arranging loans without also being licensed brokers do not bring the private lender loan under the broker's exemption to usury laws. Thus, the loan is usurious since the attorney's broker license formally expired and was invalid on the date the loan was agreed to, barring the private lender's collection of interest from the borrower. All payments now apply to the principal. [**Del Mar** v. **Caspe** (1990) 222 CA3d 1316]

Now, consider a broker who is also a **general partner** in a partnership. The partnership wants to borrow money to improve real estate it owns.

The broker/general partner negotiates with a private non-exempt lender for a loan which is to be secured by real estate owned by the partnership.

The lender funds the loan. The lender receives the partnership's promissory note and trust deed executed in favor of the lender by the general partner on behalf of the partnership. The rate of interest called for in the promissory note exceeds the usury threshold rate.

The partnership timely repays the loan and the lender reconveys the trust deed. The partnership then demands the lender return all interest paid on the loan, claiming the loan was usurious.

Is the partnership entitled to a refund of interest paid on the loan?

Yes! The general partner is not acting in the capacity of a licensed broker when he negotiates a loan on behalf of the partnership, he is acting as its general partner. [**Green** v. **Future Two** (1986) 179 CA3d 738]

*Editor's note — Another California appeals court held in a nearly identical factual situation — tenants in common acting as a group — that the broker acting on behalf of a partnership of which he is a member is considered to be acting for others and thus operating in his licensed capacity. [**Stickel** v. **Harris** (1987) 196 CA3d 575]*

However, the court in Stickel did not have a firm grasp on brokerage law or the rule that tenants in common constitute a tenancy in partnership. The analysis in the case is faulty as its conclusion relies on the erroneous assumption a broker's license is required for a general partner to deal with real estate owned by the partnership.

No broker fee was received or was to be paid to any real estate broker for the act of negotiating the loan for the group. The general partner received only the benefits he would have received as a partner, whether or not this loan was originated. Thus, he did not receive a fee or "arrange" the loan as a broker on behalf of the group as required to qualify it for exemption from usury laws.

Agents and usury

Activities of a licensed real estate sales agent are not within the broker's usury exemption, unless the agent is employed by a broker and the agent's level of participation in the transaction constitutes arranging the loan.

For example, an owner wants to refinance a loan secured by real estate he owns. The owner contacts a broker and they discuss acceptable terms for the loan. A loan application is submitted and loan disclosures are made by the broker.

The broker prepares a loan package and submits it to different lenders, but is unable to find a lender to fund the loan. The broker then informs an affiliate with whom he shares office space about the unfunded loan. The affiliate is a licensed real estate agent who is not registered with the DRE as employed by a broker. The agent locates a private lender who funds the loan. The interest rate called for in the note exceeds the usury threshold rate for the loan.

The agent receives a fee paid directly to him by the borrower. The agent does not split the fee with the broker, but he does use a portion of his income to pay joint office expenses.

The owner makes all payments due on the loan and the lender reconveys. The owner then demands a refund of all interest paid, claiming the loan was usurious since it was arranged by a licensed sales agent, not a broker.

Is the owner entitled to a refund of the interest?

No! The initial terms for the loan were established with the borrower by the broker on a loan application. The broker's involvement in packaging the loan transaction and shopping the loan for placement with a private lender is sufficient for the loan to be considered arranged by a broker.

Although the broker did not receive direct compensation from the owner, he did receive indirect compensation for his involvement since the agent who took a fee contributed to common office expenses. Thus, the loan is exempt from usury limitations. [**Jones** v. **Kallman** (1988) 199 CA3d 131]

Now consider a sales agent who arranges loans for an unlicensed private lender while employed as an agent of a broker. The agent terminates his affiliation with the broker, but does not inform the lender.

Later, a borrower contacts the now **unemployed agent** seeking a loan to be secured by real estate owned by the borrower. The salesman arranges the loan which is funded by the private lender he had contact with while previously employed by a broker.

The borrower executes a note and trust deed in favor of the lender. The interest called for in the note is in exceeds the usury threshold rate. The salesman is paid a fee for arranging the loan. After making several interest-only payments, the borrower defaults and the lender initiates foreclosure.

The borrower claims he owes no interest to the lender, and all interest paid is to be credited to principal, since the loan was not arranged by a licensed real estate broker and the rate of interest on the loan exceeds the usury threshold rate.

Can the borrower avoid paying any interest on the loan since no broker was involved and the real estate salesman was not working with a broker at any time while arranging the loan?

Yes! For a loan arranged by a salesman to be exempt from usury laws, the salesman must be working with a broker while arranging the loan. Since the salesman was not employed by or affiliated with a broker at any time during his arrangement of the loan. The loan is not exempt from usury laws. [**Dierenfield** v. **Stabile** (1988) 198 CA3d 126]

Chapter 42 Usury and the carryback note

This chapter illustrates the continued exclusion of carryback notes from usury laws after modification.

Modified, assigned or unconscionable rates

The maximum rate of interest which can be charged on a **non-exempt loan** secured by real estate is the greater of:

- 10% per year; or
- the aggregate rate comprised of the discount rate at the Federal Reserve Bank of San Francisco (FRBSF) and a margin figure of 5%. [Calif. Constitution Article XV §1]

Consider a buyer and seller who enter into a purchase agreement for the sale of real estate. The purchase agreement calls for a down payment with the balance of the price being evidenced in a note and trust deed in favor of the seller, also called a *carryback sale, credit sale* or *installment sale*.

The terms of the carryback note prepared by escrow and delivered to the seller under the terms of the purchase agreement call for the buyer to make monthly payments of **interest only**. The principal is due one year after the close of escrow. The interest rate negotiated for the carryback note is 20%.

The buyer defaults on the carryback note and trust deed after making payments for several months. The seller begins foreclosure on the real estate under the trust deed.

The buyer claims the seller cannot foreclose since the interest charged on the note is in excess of the rate allowed by usury laws, rendering the interest provisions in the note void. Thus, the buyer claims no payments are due until the principal is due, and all payments made are to apply only to principal.

Can the note carried back by the seller ever, at any rate of interest, be usurious?

No! A carryback debt is the result of a **credit sale** by the seller. It is not a loan or forbearance of a loan made by a lender. Thus, a carryback debt is not subject to the interest limitations of usury laws. [**Verbeck** v. **Clymer** (1927) 202 C 557]

Usury laws apply only to a **loan or forbearance** of money, goods, or contract rights covering *chose in action*. [Calif. Const. Art. XV §1]

Carryback modified at usurious rates

Consider an installment sale of real estate to a buyer on terms which include the execution of a note in favor of the seller for a portion of the sales price. The note includes a due date for a final/balloon payment.

When the due date for payment of the entire remaining principal arrives, the buyer defaults on the carryback note and trust deed.

The buyer and seller agree to extend the note's final due date for payment of the principal owed. In exchange, the buyer agrees to an increase in the note's interest rate, raising the rate above the usury threshold rate. Thus, the seller's yield on the debt after the modification exceeds the rate ceiling set by usury laws.

The buyer makes all payments due on the modified carryback note, including the final/balloon payment.

The buyer then makes a demand on the seller to return all the interest paid after the modification, claiming the seller's modification of the note was a **forbearance** controlled by usury limitations.

Is the buyer entitled to recover the interest paid after the modification in the rate of interest due on the carryback debt?

No! The transaction in which the debt was created was a credit sale, a debt not subject to usury laws. Although the terms of the note evidencing the carryback debt were modified and a **forbearance** (such as a cancellation of foreclosure) did occur, the status of a carryback debt does not change to transform the debt into a loan. Thus, a loan modification of the terms for payment—an interest rate increase—does not subject the debt to usury laws since the debt is not a loan. [**DCM Partners** v. **Smith** (1991) 228 CA3d 729]

Consider a buyer of real estate who acquires the property and takes over an existing trust deed lien which secures a note carried back by a **prior owner** of the property.

Later, the buyer defaults on the carryback note and trust deed. The holder of the note and trust deed initiates foreclosure.

Prior to the foreclosure sale, a pre-foreclosure workout agreement is negotiated between the buyer and the holder of the trust deed. The original carryback note is **canceled** and the trust deed lien is **reconveyed**.

In exchange for canceling the note, the buyer signs and delivers a new note and trust deed in favor of the holder of the canceled carryback note and reconveyed trust deed. The new note is secured by the same property as described in the new trust deed.

The new note is for a greater amount than the principal amount which remained on the carryback debt since the holder of the note was given a bonus for restructuring the debt which was added to the unpaid debt. Also, the interest rate is increased on the new note.

The **higher yield** on the new note resulting from the modified note rate and bonus paid to the holder of the trust deed exceeds the maximum annual average yield allowed over the life of the debt by usury laws.

After paying off the new note, the buyer demands the return of all the interest paid on the new note, claiming it was the result of a **forbearance** which brought the carryback debt under the protection of usury laws.

Is the holder of the new note entitled to retain the interest bargained for and paid on the note?

Yes! The new note evidenced a **restructuring** of the original credit sale debt, and the debt **remained secured** by the property originally sold. As a *rollover* of the debt created in a credit sale into a new note

and trust deed lien on the property sold, the debt retained its original characteristics as a **carryback debt**. Restructuring the carryback debt with a new note and trust deed did not make the debt a loan, and unless the debt is a loan it is not subject to usury laws. [**Ghirardo** v. **Antonioli** (1994) 8 C4th 791]

Loan disguised as a carryback

While the modification of a carryback note on a default does not convert the debt into a loan and thus the debt is not controlled by usury laws, a loan transaction disguised as a carryback sale is subject to usury laws. The documentation for a loan as a carryback transaction is merely a sham, *a masked loan transaction*.

For example, a seller of real estate negotiates with a buyer to **cash out** his equity in the property and assume the existing loan. However, the buyer does not have the cash reserves to cash out the seller's equity.

The buyer is referred to a private lender (who is not licensed as a real estate broker in California). The lender the buyer contacted is willing to lend the buyer the additional money needed to cash out the seller.

However, the rate of interest demanded by the unlicensed private lender exceeds the maximum yield allowed by usury laws.

Rather than lend the money directly to the buyer, the lender requires the sales transaction be restructured as a carryback note executed by the buyer in favor of the seller, payable on terms dictated by the lender. The lender will purchase the note by *assignment* from the seller concurrent with the close of the sales escrow.

Thus, the buyer will cash out the seller's equity in a two-step transaction consisting of the buyer's down-payment funds and the lender's funds structured as payment for the seller's **assignment** of the carryback note to the buyer's lender.

Will the lender's plan to structure his advance of funds as a purchase of a carryback note by an assignment from the seller avoid the interest limitations of usury laws?

No! Although the transaction on its face appears to be a credit sale and an assignment of a carryback note to a trust deed investor, the **initial purpose** for the involvement of the trust deed investor was to loan money to the buyer. As a loan transaction initiated and negotiated by the buyer to obtain purchase-assist funds from an unlicensed private lender without the involvement of a broker in the loan transaction, the transaction is a loan and is subject to usury law limitations on its annual yield. [**Harris** v. **Gallant** (1960) 183 CA2d 104]

Editor's note — One way for the private lender to exempt his loans from the limitation on interest rates imposed by usury laws is to retain a licensed real estate broker to arrange the loan (or become licensed as a real estate broker himself), since all loans ***made or arranged*** *by licensed brokers and secured by real estate are exempt from usury limitations. [Calif. Const. Art. XV]*

The carryback sold to a lender

Consider a buyer and seller in reverse roles from the previous example but with the same goal of cashing out the seller on close of the sales escrow. The seller, not the buyer, is the one who initiates negotiations to sell a carryback note and trust deed to an investor, an unlicensed private lender. The buyer and seller

enter into a purchase agreement calling for the buyer to make a down payment and execute a note and trust deed in favor of the seller for the remainder of the purchase price, closing contingent on the seller assigning the note to a trust deed investor.

From the outset of negotiations, the seller intends to immediately sell the carryback note to a trust deed investor. To assure the note can be sold, the seller (not the buyer in this example) structures the terms of the carryback note for sale to a trust deed investor. A trust deed investor approves the buyer's credit history before the seller waives the contingency for further approval of the buyer's credit. [See **first tuesday** Form 150 §8.5]

The yield the trust deed investor is to receive for the funds he advances to acquire the note and trust deed exceeds the usury limits.

The sales escrow closes concurrent with the trust deed investor funding his purchase of the carryback note by an assignment from the seller.

Later, the buyer claims the note is usurious and he owes no interest to the trust deed investor since the creation and sale of the carryback note was a sham designed to circumvent usury laws.

However, the carryback note evidenced a debt intended by the buyer and seller to arise out of a valid credit sale. The trust deed investor was not brought in by the buyer to make a loan, but was sought out by the seller to purchase the note the seller intended to carryback and resell.

No recharacterization or alteration of the purchase agreement or the sales escrow instructions was required to complete the seller's sale of the carryback note by an assignment of the note to the trust deed investor. Thus, the seller may freely **assign his carryback note** to the trust deed investor, and the assignment does not transform the carryback debt into a loan which would subject the debt to the annual yield limitations of usury laws. [**Boerner** v. **Colwell Company** (1978) 21 C3d 37]

Unconscionable interest rates

Although a carryback note and any modification of the note are exempt from usury laws, there are limits for interest rates which are enforceable.

For example, a buyer with a 5% down payment is able to obtain financing for only 80% of the purchase price. The seller agrees to carry back a second trust deed note for the remainder of the purchase price, but demands an interest of 20% per annum to cover his risk of loss, all due within six months from the close of escrow.

The buyer agrees to the seller's terms for the carryback note since he believes he can obtain the funds necessary to pay it off prior to the due date.

When the due date arrives, the buyer remains unable to obtain funds to pay off the carryback note. The buyer defaults on the note and the seller begin foreclosure proceedings.

Prior to the foreclosure sale, the seller offers to extend the due date of the note for one year, provided the buyer agrees to increase the interest rate to 200%. The buyer, not wanting to lose his equity in the property and with property values having risen, agrees to the increased interest rate.

Interest payments under the restructured carryback agreement are made for six months when the buyer again defaults on the note. As before, the seller begins foreclosure proceedings.

The buyer claims he is not liable for the interest since the note is usurious and the result of an *unconscionable economic advantage* acquired by the seller.

The seller claims the note is not subject to usury laws since it evidences a carryback debt and the voluntary modification of the annual rate of return is justified based on the risk of loss inherent in a 95% loan-to value ratio (LTV) and fast rising mortgage rates.

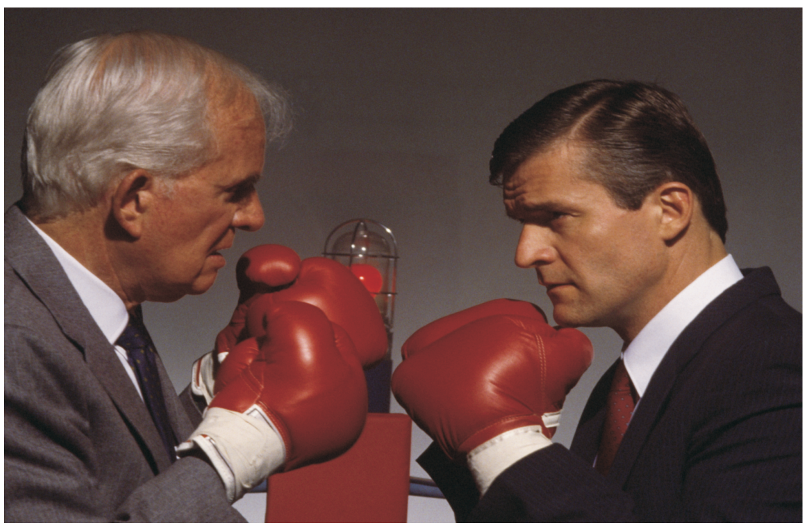
Is the seller correct that this note can avoid the usury issue?

Yes! The carryback note evidences a debt owed to the seller which is secured by the property sold, the result of a *credit sale*. Thus, the debt, modified by the extension and rate increase, is not a loan and is not subject to usury laws.

However, the seller is incorrect on the issue of an **unconscionable rate**. The interest rate provision of the note is so unconscionably high as to be shocking to a court. Thus, as an unconscionable annual rate of return on the debt, the excessive rate is not enforceable by the carryback seller. [**Carboni** v. **Arrospide** (1991) 2 CA4th 76]

SECTION F

Recourse and Nonrecourse Loans



Chapter 43 — Anti-deficiency: past, present and future

This chapter discusses the history, purpose and application of anti-deficiency laws as a buyer's defense from lender claims of personal liability for payment of debts secured by real estate.

Are buyers losing their shield?

A buyer of real estate who executes a promissory note for a debt, in favor of either a lender or a carryback seller, agrees to pay the dollar amount owed as promised. This promise, if unsecured, is enforced under basic contract law.

However, while securing the debt by a trust deed lien on real estate does not abolish the buyer's *personal obligation* under his promise to pay, the inclusion of real estate as security places the enforcement of the debt under mortgage law, with dramatically different results from contract law for all involved.

A lender or carryback seller, by accepting real estate as security for the repayment of a debt, alters his method and ability to force the borrower to pay on that promise. When real estate is taken as security, it, not the borrower, becomes the primary source of the lender's recovery should the borrower default. Under mortgage law, a trade-off occurs for giving and getting real estate as security for a debt.

Thus, the lender or carryback seller holding a note secured by real estate is forced to **foreclose** by selling the real estate before attempting any other method of collection to satisfy an unpaid debt on a default. The borrower forces the noteholder to take (read that as buy) the property he has put up as security by merely defaulting on his promise to pay.

A default is the borrower's act of exercising the *put option* contained in the provisions of all trust deeds. On default, the lender is required to take the property in exchange for amounts owed. [Calif. Code of Civil Procedure §726]

A further limitation is placed on a mortgage lender's ability to recover losses incurred in a foreclosure when the property's value is insufficient to satisfy the note and the underlying debt, legally classified as *purchase-money debt*. Examples of **purchase-money debt** include:

- an installment sale – **carryback note** – on the sale of any type of property; and
- the **purchase-assist funding** of a one-to-four unit residential property occupied by the buyer. [CCP 580b]

Editor's note: Purchase-money debt does not include purchase-assist loans which fund the purchase of property other than one-to-four residential units.

Occasionally, the fair market value (FMV) of the secured real estate at the time of the foreclosure sale is insufficient to satisfy the debt. Yet the buyer as **maker** of the promissory note is still *personally responsible* for the amount remaining unsatisfied after foreclosure.

However, to **enforce collection** by obtaining a *money judgment* for losses based on an underbid at the foreclosure sale, the lender or seller holding the note must have structured the transaction to deprive the buyer of an *anti-deficiency defense*. To collect the deficiency in the secured property's value to fully satisfy the debt, the debt must be recourse in nature and the foreclosure must be judicial.

Until the 1930s, the signer of a note evidencing any type of debt secured by any type of real estate remained *personally liable*, not just responsible, Thus, the signer was liable for any deficiency in the property's value and subject to an award of a **money judgment** after either a judicial or nonjudicial (trustee's) foreclosure sale on the property.

For example, a lender in 1929 holds a note which evidences a loan secured by a trust deed lien on the borrower's principal residence, which was purchased by the use of loan funds.

The homebuyer defaults on the note. The lender forecloses by a trustee's sale and recovers the property for **less than its FMV** by entering a credit bid for a fraction of the dollar amount of the secured debt, called an *underbid*.

Prior to the mid-1930s, the lender would then sue the borrower and be awarded a money judgment for the difference between the amount of the **underbid** and the amount due on the note, the value of the property taken by the lender being of no concern.

After the payment of the money judgment, the homebuyer would not be entitled to recover the property. Foreclosure by a trustee's sale barred any later redemption or recovery of the real estate by the wiped-out homebuyer and was not a defense in court to avoid a money judgment.

Thus, in addition to losing the secured real estate, the homebuyer or investor would also remain burdened with the responsibility of paying off the balance of a debt he incurred to buy property he now no longer owns or can recover.

This Great Depression scenario, allowing the lender to acquire the property on an underbid at a trustee's sale and also obtain a money judgment against the borrower for any remaining balance due on the note, came to an end in California in the late-1930s.

Unjust deficiencies eliminated

In the 1920s, the economy was booming. Real estate values were high and rising, and real estate prices and public confidence in the future were even higher, not unlike the giddy mid 2000s.

However, the 1930s ushered in an economic depression which, due in part to the abrasive foreclosure practices of lenders and carryback sellers (as well as a penurious, moral-stricken Federal Reserve), devastated values in the real estate market.

Along with the economy and banks, real estate values plunged, foreclosure sales were rampant and the loss of homeownership escalated out of control.

With the additional burden of an owner's personal liability for a deficiency in his property's value, the chances of financial recovery for most owners who lost property through a trustee's foreclosure were slim. The easiest way to effectively escape from the judgment and the arm of the law was to move to another state.

In the 1930s, to curb the negative impact that the drastic increase in foreclosure sales and the resulting money judgments and displacement of owners was having on the region's economy, the California legislature enacted **anti-deficiency laws** which included:

- a limitation on the **amount recoverable** as a money judgment for debts secured by real estate, set as the difference between the amount due on the note and a court-established fair market value (FMV) of the property (lender's security interest) at the time of a judicially ordered foreclosure sale, called a *deficiency* [CCP §580a];

- a prohibition against money judgments being obtained by lenders and carryback sellers for any deficiency in property value on any type of foreclosure by limiting their recovery solely to the value of the secured property when, 1) the lender's loan funded the purchase and was secured by a one-to-four unit residential property occupied by the borrower as his principal residence, or, 2) the debt was incurred by the buyer as a carryback note on the seller's installment sale of any type of real estate which was the sole security for the debt [CCP §580b]; and

- a bar against any creditor secured by real estate from obtaining a money judgment for a deficiency after completing a **trustee's sale**. [CCP §580d]

The shift in the risk of loss

Anti-deficiency rules used as a defense by a property owner to avoid liability for payment of a *purchase-money* note shift the **risk of loss** for the unpaid loan balance or portion of the price paid for real estate from the buyer to the lender or carryback seller holding the note. **Purchase-money** notes are also called *nonrecourse* notes.

When the real estate securing *purchase-money* paper drops in value, the potential for loss increases for the holder of the paper. Then, on a default, the lender or the carryback seller often minimize their loss through pre-foreclosure workouts. The lender or seller might realistically go so far as to accept a *short payoff* on a sale of the property by the owner, in full satisfaction of the debt.

By accepting the net proceeds from the owner's sale of the secured property in exchange for cancelling the outstanding loan balance — sometimes called a **short payoff** — the lender or carryback seller avoids the costs of both:

- foreclosure; and
- ownership resulting from acquisition of the property at foreclosure.

While prompting lenders and carryback sellers to minimize their potential losses, anti-deficiency rules protect the property owner by balancing the risks of each other's losses during times of economic reversal.

Taxwise, an owner who participates in a short payoff of a **nonrecourse loan** incurs no reportable *discharge-of-indebtedness income* when the owner's original purchase price of the secured property is greater in amount than the principal remaining on the debt prior to the payoff. [**Commissioner of Internal Revenue** v. **Tufts** (1983) 461 US 300]

Overinflated prices for profit

Anti-deficiency laws shift the risk of loss on a note signed by the buyer in favor of a *purchase-money* lender or carryback seller which arises when the value of the secured real estate is inadequate to fully satisfy the debt, a mortgage leveraging condition called *negative equity*.

For example, sellers of property who carry back a note in an installment sale based on an inflated price and secured only by the property sold are financially restrained from recovering all the price they bargained for should the value of the property at the time of the foreclosure sale be less than the amount owed. The sole source of recovery for a carryback seller with no additional security is the property sold. No recourse is available to the buyer's other assets.

Consider a seller of real estate who locates a buyer willing to pay an inflated price for the property, or a situation in which the price was at market but the property later suffers a drop in value.

To help finance the buyer's purchase of the property, the seller carries back a note secured by a trust deed lien on the property he sold.

Later, the buyer defaults on the carryback note, realizing the property is over encumbered for its value and has no equity. The seller forecloses, judicially or nonjudicially, and the property is sold at a foreclosure sale for less than the amount owed on the note.

The seller seeks to recover his loss on the note due to the deficiency in the property's value. Here, the carryback seller is barred by anti-deficiency legislation from enforcing collection of any deficiency in the value of the property at the time of the foreclosure sale, regardless of the type of foreclosure sale employed. The note was for credit extended by the seller on the sale of property and the property sold was the sole security for that debt. [CCP §580b]

The carryback seller whose property's sales price is inflated, or whose property experiences a drop in value after it is sold, will not benefit beyond the price received at the foreclosure sale.

Marketplace drop in property value

The value of the real estate securing a **purchase-money debt** may become inadequate to cover the debt due to falling real estate values caused by a local or general economic downturn, as opposed simply to an unrealistically inflated price at the time of sale.

Here, anti-deficiency laws are intended to ensure that an economic downturn is not aggravated beyond the usual cyclical increase in foreclosure sales. Thus, as a matter of public policy to avoid the deepening of a recession, buyers of any type of real estate on an installment plan are not held personally liable for those purchase-money debts. [**Roseleaf Corporation** v. **Chierighino** (1963) 59 C2d 35]

Also, consider a home buyer who obtains a 30-year purchase-assist loan from a lender which funds the purchase of a one-to-four unit residential property he occupies as his principal residence.

A few years later the local economy becomes depressed, causing the fair market value of the property to drop below the unpaid balance on the loan. The borrower defaults and the lender reacquires the property on an underbid at a foreclosure sale.

The underbid at the foreclosure sale results in an unpaid balance remaining on the debt.

Can the lender who funded the purchase-assist loan secured by the buyer-occupied, one- to-four unit residential property, enforce collection of the unpaid balance remaining on the note?

No! The lender is barred from obtaining a deficiency judgment in any amount, regardless of the type of foreclosure he may pursue, be it judicial or nonjudicial. The purchase-assist loan is classified as a **purchase-money** loan since it funded the purchase of the property and was secured by a one-to-four unit residence which was occupied by the buyer on acquisition. [CCP §580b]

Consider a seller who carries back two notes on the sale of a single parcel of real estate after a 5% down payment. Each note evidences separate amounts due the seller, totaling 95% of the property's total sales price. One note in an amount equal to an 80% loan-to-value (LTV) ratio is secured by a trust deed on the property sold. The other note for 15% of the sales price is secured by a trust deed on other property owned by the buyer. The notes are not *cross collateralized* and a default on one note does not constitute a default on the other under the *dragnet clause* in the trust deeds. [See **first tuesday** Form 154 §4]

The buyer defaults on both notes.

The seller completes a trustee's foreclosure sale under the trust deed he carried back on the property he sold to the buyer. A judicial foreclosure is later initiated against the buyer's other property under the separate note and trust deed in an effort to recover what will be a deficiency in the other property's value at the time of the judicial foreclose sale.

The buyer claims the judicial foreclosure on his other property violates anti-deficiency law since the second foreclosure is an attempt to recover a deficiency on the price the buyer paid for property he no longer owns and the seller recovered by a trustee's sale.

Can the seller foreclose on the buyer's other property under the separate debt (note) and trust deed?

Yes! The foreclosure on the other property does not violate anti-deficiency law. A carryback debt secured by a property other than the property sold is not subject to anti-deficiency law. [**Hodges** v. **Mark** (1996) 49 CA4th 651]

In this example, the buyer, when negotiating to secure the carryback note with a trust deed lien on other property other he owned rather than the property he purchased, should have considered arranging for the inclusion of an *exculpatory clause* in the note. An **exculpatory clause** converts recourse paper into non-recourse paper by eliminating personal liability for any deficiency in the value of the secured property. [See Chapter 6; see Form 418-5 §2.2 accompanying this chapter]

Anti-deficiency waiver barred

Consider a lender or carryback seller attempting to collect on a note which the provisions of a modification agreement converted the debt to a recourse debt.

For example, a carryback seller of unencumbered property bargains for and receives two notes evicencing separate amounts of the sales price remaining to be paid. The notes are separately secured by first and second trust deeds on the real estate he sold, an 80-10-10 financing arrangement called piggyback financing. Later, the buyer arranges for a lender to refinance the balance due on the carryback seller's first trust deed note.

However, as a condition for recording the refinancing, the seller must subordinate his second trust deed to the lender's new trust deed so the refinancing will have priority as a first trust deed lien on the property.

The carryback seller agrees to reconvey his first trust deed and subordinate his second trust deed to the refinancing, if the buyer:

- **personally guarantees** the note he executes; and

- signs a **written waiver** of any anti-deficiency protection.

The buyer agrees and enters into a guarantee agreement and a modification of the second trust deed note. The seller enters into a **specific subordination agreement** allowing his original second trust deed to remain a second, junior in priority to the new trust deed. The lender's trust deed and the subordination agreement are recorded on closing the loan escrow.

The buyer then defaults and the first trust deed lender forecloses on the property, wiping out the second trust deed held by the carryback seller. The carryback seller now seeks to recover the balance due on the second trust deed note since his trust deed interest in the property has been exhausted by the foreclosure on the first trust deed.

The seller claims he is entitled to a money judgment on the purchase money debt since the buyer personally guaranteed the debt and signed a waiver relinquishing his anti-deficiency protection in consideration for the seller subordinating to new financing.

The buyer claims the personal guarantee and the waiver of anti-deficiency protection are unenforceable attempts by the seller to circumvent anti-deficiency law on a carryback debt.

Can the carryback seller enforce collection on the note or under the personal guarantee for the balance due on the note following subordination of his trust deed lien to refinancing?

No! The buyer is not liable on the note or his guarantee. The seller's carryback debt remained secured by a trust deed on the property sold, no additional or other property involved. Any guarantee or agreement under which the buyer purports to waive his anti-deficiency protection without a substitution of property as security is unenforceable. [**Palm** v. **Schilling** (1988) 199 CA3d 63]

Only a third party executing a **guarantee agreement** can be personally liable for amounts due on a purchase-money note. [See Form 439 in Chapter 13]

Consider a seller who carried back a note and trust deed on a property he sold. Later, during a real estate recession, the buyer of the property defaults and is unable to sell the property or borrow funds to pay off the note. The seller commences foreclosure by recording a notice of default (NOD).

Prior to the trustee's sale, the buyer and seller *modify* the note to include a (contract) provision stating the buyer waives his anti- deficiency protection in exchange for the seller canceling the NOD.

Ultimately, the first trust deed holder forecloses, wiping out the seller's second trust deed. The carryback seller seeks to recover the amount owed him on the note since his security interest under the trust deed lien has been *exhausted* by the first trust deed lienholder's foreclosure.

The buyer claims the seller is barred from any recovery on the note since **enforcement of debt** created to pay the seller in an installment sale of real estate is subject to anti-deficiency defenses held by the buyer which cannot, as a matter of *public policy*, be waived.

NOTE ENFORCEMENT PROVISIONS

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a Promissory Note

1.1 ☐ of same date, or dated _____________, 20______, at ______________________________, California,

1.2 entered into by ____, as the Payor,

1.3 in favor of ____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as ____

____

____.

AGREEMENT:

2. In addition to the terms of the above referenced Promissory Note, Payee agrees to the following checked provisions:

2.1 **Guarantee provision**

☐ The Note is guaranteed by ____________________________________, under a Guarantee Agreement dated _____________, 20______, at ________________________________, California. [See **ft** Form 439]

2.2 **Exculpatory provision**

☐ Enforcement of the Note and Trust Deed is subject to the purchase money anti-deficiency provisions of Code of Civil Procedure §580b.

2.3 **Governing law provision**

☐ This Note is governed by California law.

Payor's name: _________________________________	Payor's name: _________________________________
Signature: ____________________________________	Signature: ____________________________________
Payor's name: _________________________________	Payor's name: _________________________________
Signature: ____________________________________	Signature: ____________________________________

FORM 418-5 04-08

The seller claims the buyer waived his anti-deficiency protection by an agreement in writing which **modified** the note and trust deed in exchange for the seller's forbearance of foreclosure by canceling the NOD.

Can the seller recover on the carryback debt based on the modification and waiver agreement?

No! Recovery on the modified note, which evidences a carryback debt secured only by the property sold, is barred by anti-deficiency rules even though the buyer waived his anti-deficiency protection. Any waiver of anti-deficiency protection by the buyer while the carryback debt remains secured solely by the property sold is unenforceable as against public policy. [**DeBerard Properties, Ltd.** v. **Lim** (1999) 20 C4th 659; CCP §580d]

Deficiency judgment and one year redemption

The public policy objective behind anti-deficiency legislation is to protect property owners and dissipate the "debtor's prison" aura which surrounds defaulting owners who would both lose their property and be subject to a money judgment. [Palm, *supra*]

A lender holding a **recourse note** can foreclose judicially and obtain a deficiency judgment if the fair market value of the secured property at the time of the judicial foreclosure sale has fallen below the amount of the debt. However, the borrower has the right to **redeem the property** within one year after the judicial foreclosure sale by paying the amount of the bid (plus interest) when a money judgment for the deficient value is awarded to the lender. The money judgment is a separate debt, unconnected to the right to redeem the property for the price bid at the foreclosure sale. [CCP §729.030]

As a consequence, a **judicial foreclosure** is costly to the lender both in time and money. Also, the lender faces the risk of a further decline in the property's value during the one-year redemption period after the foreclosure sale, as well as the risk of being unable to recover a money award.

Thus, a trust deed lender holding a recourse (or nonrecourse) note can foreclose quickly and inexpensively through the trustee's sale procedure. The owner's *right to redeem* the property by payment of the debt in full is terminated on completion of the trustee's sale.

To counterbalance the beneficial right of a recourse lender to a swift foreclosure by use of a trustee's sale, the recourse lender is **barred from obtaining** a deficiency judgment after foreclosing nonjudicially on the property. While an owner has no right to redeem the property after a trustee's sale, he does have the right to redeem the property after completion of the judicially ordered sheriff's sale. [CCP §580d]

The reemergence of anti-deficiency law

When faced with an economic downturn, such as the real estate recession which lasted the entire first half of the 1990s, homeowners and installment sale buyers need the protection of anti-deficiency laws against lenders and carryback sellers if they are to continue to live in California and contribute to the state's economy. This same economic scenario looms for the great recessionary period following 2006.

However, signs of the erosion within the long-standing public policy behind the anti-deficiency defense against excess lending on secured debt can be seen in the California legislation which was passed to benefit lenders and carryback sellers in 1994, as well as removal of cramdown authority on single family residences from the federal bankruptcy law in 2005.

Lenders are very good at lending too much money when profits remain *privatized* and later lobbying governments to cover errors in lender judgment by *socializing* their losses.

As a result, lenders and carryback sellers can circumvent California's anti-deficiency defense by requiring borrowers and buyers to provide a *letter of credit* as a condition for financing, unless the financing funds or extends credit for the purchase of an owner-occupied, one-to-four unit residential property. [CCP §§580.5; 580.7]

Although the borrower is ultimately liable for repayment of any amounts drawn by the lender or carryback seller on the **letter of credit**, the lender or carryback seller holding the letter of credit is no longer barred from using it before or after a **trustee's foreclosure** has been completed to recover any deficiency due to an underbid. This procedure is quicker and slicker than the alternative involving a judicial foreclosure, appraisals, a money judgment and pursuit of its collection.

Additionally, a letter of credit has been legislatively re-classified. It may no longer be legally considered a guarantee or additional security, although the economic function of enforcing a letter of credit has the same economic function as the enforcement of a guarantee or pursuit of the additional security.

Unlike a guarantor, the issuer of a letter of credit, usually a banker, does not receive the same protection as would a guarantor signing a guarantee. A guarantor is entitled to a notice of foreclosure and an opportunity to purchase the guaranteed note before the completion of a foreclosure on the property, unless the guarantor waives his right to a notice in writing. [See Form 439 in Chapter 13]

Further, unlike additional security, a letter of credit can be drawn on by a lender or carryback seller before completing a judicial foreclosure. The draw does not then bar the foreclosure for having enforced collection **without first foreclosing on** to the secured property, called the *one-action rule*.

Borrowers currently protected from the letter of credit device are homebuyers, small-time investor/occupants of one-to-four unit residential properties, and those borrowers who refuse to provide a letter of credit that would allow the lender to draw on it at any time.

Ironically, in the 1990s, during the second greatest economic downturn in California during the twentieth century, the state legislature passed laws diminishing the effects of prior legislation designed to protect borrowers and create a viable economic environment which would induce borrowers who have gone bust to remain in California as contributing residents.

A letter of credit is now legislatively considered a **source of payment**, not a form of security, which is available to be called on by the lender at any time. Thus, a borrower defaulting on any debt secured by real estate (excluding an owner-occupied, one-to- four unit residence) and accompanied by a letter of credit, has lost the much needed protection that anti-deficiency law provides against reckless lending, boomtime mentality and dramatic declines in the real estate economy.

Chapter 44 Converting nonrecourse paper into recourse paper

This chapter explains how a nonrecourse note held by a lender or carryback seller becomes recourse paper through later agreements with the property owner.

Eliminating or substituting security

A seller holds a carryback note secured by a third trust deed on real estate he sold, called a *purchase-money* note since a deficiency in the value of its security is not collectible.

The buyer defaults and on investigating the financial feasibility of foreclosing and repossessing the property, the seller decides to forgo foreclosure. [See Form 303 in Chapter 30]

The buyer wants to retain the property, but needs the seller to subordinate his trust deed to a new first trust deed loan.

The seller offers to reconvey the carryback trust deed in exchange for the buyer executing a new note for the debt owed, but secured by a junior trust deed on real estate other than the property sold. The buyer provides security – a trust deed position on other property – which the seller accepts.

By mutual agreement between the buyer and the seller:

- the seller cancels the purchase-money note and reconveys the carryback trust deed; and
- the buyer signs and delivers a new note and trust deed in favor of the seller, secured by other real estate owned by the buyer.

While the buyer **substituted security** for an existing debt owed to the seller, the new note merely evidences the same debt which was represented by the canceled note.

Later, the holder of the first trust deed on the substituted security forecloses, eliminating the seller's trust deed lien from title, called an *exhaustion of the security*.

Since the carryback seller's substituted security interest has been eliminated and the buyer refuses to pay, he sues the buyer to obtain a money judgment for the unpaid amount of the note.

The buyer claims the seller is barred by anti- deficiency rules from collecting on the note since the note evidences a purchase-money debt created between the buyer and the seller to finance the sale of real estate. [Calif. Code of Civil Procedure §580b]

The carryback seller claims anti-deficiency rules no longer bar him from obtaining a money judgment on the carryback debt since the debt became secured by real estate other than the property sold.

Can the seller enforce collection of a carryback debt which became secured, separately or collaterally, by property other than the property sold?

Yes! The seller can obtain a money judgment to enforce collection on the note even though it evidences a carryback debt. Anti-deficiency non-recourse rules no longer apply to a carryback debt when the debt

becomes secured by real estate other than the real estate sold, called a *substitution of security*. The carryback seller was able to sue directly on the note without first foreclosing since his security interest in property other than the property sold was wiped out by the senior trust deed foreclosure. [**Goodyear** v. **Mack** (1984) 159 CA3d 654]

If a seller is barred from obtaining a money judgment to enforce collection of a carryback note, secured by property other than the property sold, the buyer would be improperly allowed to:

- retain the property sold; and
- avoid paying the seller for the property he purchased.

Subordination with an added risk

Construction loans are naturally precarious arrangements due to the risk the improvements may never be completed to create the anticipated property value.

Consider a seller who carries back a trust deed on the sale of a parcel of real estate and later **subordinates** the trust deed to a construction loan.

Should the construction lender foreclose on the property the seller sold and wipe out the now subordinated carryback seller's trust deed lien, the seller can collect on the carryback note by obtaining and enforcing a money judgment.

For example, a carryback seller subordinates his trust deed to a trust deed recorded to secure a construction loan. The loan will fund the cost of improvements to be made on the property he sold. Since the carryback trust deed is subordinated to the loan, the risk of loss due to a failure of the development is thrust upon the seller. To cover the added risk of loss presented by the buyer's need to complete the construction, the note's interest rate is increased and prepaid for the period anticipated for construction.

Here, the trust deed note becomes recourse paper since it was subordinated to the trust deed securing the construction loan. The seller is not expected to assume the risk that the value of the yet-to-be-built improvements may not prove to be adequate security for his carryback note and cause him to suffer a loss.

Thus, the developer/buyer who promises to construct improvements as **additional security** is not protected by anti-deficiency rules from personal liability should the value of the property prove to be inadequate to satisfy the carryback note which is subordinate to a construction loan. As recourse paper, the seller is allowed to collect his losses from the developer if the property value proves insufficient to satisfy the carryback note. [**Spangler** v. **Memel** (1972) 7 C3d 603]

An **agreement to subordinate** a carryback trust deed to a future construction loan does not itself cause the trust deed note to lose its nonrecourse character. [See Form 281 accompanying this chapter]

However, the note becomes recourse paper when the carryback trust deed actually becomes subordinated to a construction loan. [**Jack Erickson and Associates** v. **Hesselgesser** (1996) 50 CA4th 182]

Conversely, the actual subordination of a carryback trust deed to the buyer's purchase-assist trust deed loan, or a later refinancing of the senior trust deed loan, does not present a change in the use or nature of the property, nor provide additional security, which would need to take place in order to convert a nonrecourse note to recourse paper. The physical property remains the same, contrary to the seller's

subordination of his security interest in the property since the seller's loan-to-value ratio (LTV) has been altered by accepting a secured position which over encumbers the property. [**Shepherd** v. **Robinson** (1981) 128 CA3d 615]

When a carryback seller agrees to subordinate his carryback trust deed to purchase-assist financing secured only by the property sold, the subordination does not alter the character of the property sold (no construction promised) or the nonrecourse nature of the seller's (undersecured) purchase-money note. [**Lucky Investments, Inc.** v. **Adams** (1960) 183 CA2d 462]

A seller who carries back a trust deed, secured only by a subordinated interest in the property sold, is charged with knowing the value of the real estate sold and thus the value of the position accepted as security.

For example, should a lack of value exist, or a market-induced reduction in the value of the property sold occur due to overpricing or a recession, the buyer is not personally liable on a seller carryback note secured by the property sold, even if the debt is later subordinated to new financing. [**Brown** v. **Jensen** (1953) 41 C2d 193]

Choice-of-law avoids anti-deficiency rules?

Consider a borrower who executes a purchase-money note secured by a trust deed on California real estate. The note contains a provision which adopts the law of another state to control the legal consequences of the financing.

The borrower and the lender are both domiciled in a state which does not have anti-deficiency laws.

The borrower defaults on the loan. The lender judicially forecloses on the property and is awarded a deficiency judgment.

The borrower claims the lender is barred from recovery by way of a deficiency judgment since the note is secured by California real estate.

The lender claims it is not barred from seeking a deficiency judgment since the transaction is governed by the law of another state which does not prohibit deficiency judgments.

Is the lender entitled to a deficiency judgment?

Yes and no! The yes part: The trust deed contained a choice-of-law provision which controlled enforcement of the California purchase-money note under **out-of-state law**. Since all parties involved were non-residents and located out-of-state, California's public policy regarding anti-deficiency is not adversely affected since no Californians are involved. Thus, the deficiency in the value of the property sold is collectible by a money judgment. [**Guardian Savings and Loan Association** v. **MD Associates** (1998) 64 CA4th 309]

*Editor's note — The no part: The **Guardian** court's holding is limited to the narrow facts of the case, i.e., all parties were non-residents living out-of-state who choose to abide by the laws of a "recourse state." Conversely, to allow **choice-of-law provisions** applying the law of a recourse state to a resident owner of property located in California would impermissibly open the door for out-of-state lenders to circumvent California's anti-deficiency laws designed to protect its residents.*

Letters of credit

A lender might require a borrower to obtain a letter of credit as a condition for funding a **purchase-assist loan**. Also, a seller agreeing to carryback paper might demand a letter of credit as additional security.

The lender or carryback seller can draw on a letter of credit before or after a trustee's sale without violating anti-deficiency statutes or the security first rule. [CCP §580.5(b)]

However, the letter of credit is unenforceable if:

- it is issued to a trust deed beneficiary to cover a future default on the obligation; and
- the obligation is secured by a purchase money trust deed on owner-occupied, one-to-four unit residential property. [CCP §580.7(b)]

Thus, a carryback seller or a purchase money lender on an owner-occupied, one-to-four unit residential property is barred from drawing on a letter of credit at any time.

Reconveying the trust deed

A lender or carryback seller holding a note secured by a trust deed cannot **unilaterally waive and reconvey** the note's security, then proceed against the borrower or buyer as though the now unsecured note was converted to recourse paper by the release of the security.

A *release of the security* must be **mutually agreed to** between the lender and borrower for the secured debt to become a recourse debt.

For example, a carryback seller holds a note for the balance due on the purchase price of real estate. The note is secured by a second trust deed on the property sold.

The property value has decreased below the amount owed on the note, due to a destabilized real estate market, and the buyer defaults.

The carryback seller agrees with the buyer to modify the terms of the note and release the security. He senses the security interest he holds under his trust deed lien on the property has insufficient value to protect should the first trust deed holder foreclose.

As agreed, the carryback seller reconveys the trust deed and the carryback note becomes unsecured. [See Form 472 in Chapter 13]

The Modification of the Promissory Note, executed by the buyer in favor of the seller, is attached to the note as an allonge and states the changes in its terms and the release of the trust deed lien by reconveyance. [See Form 425 in Chapter 55]

Later, the buyer defaults on the now unsecured note held by the carryback seller, who in turn sues the buyer for a money judgment to recover the balance due on the note.

AGREEMENT TO SUBORDINATE

NOTE: This agreement to subordinate results in your security interest in the property becoming subject to and of lower priority than the lien of some other or later security device.

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
- ☐ Purchase agreement
- ☐ Escrow instructions
- ☐ Trust deed
- ☐ ____

1.1 dated _____________, 20______, at ____, California,
1.2 entered into by ____, as the Buyer/Trustor, and
____, as the Seller/Beneficiary,
1.3 regarding real estate referred to as ____
____.

AGREEMENT:

2. Provided Trustor is not in default on the Beneficiary's trust deed, Beneficiary shall, on written request of Trustor, subordinate his trust deed to a new first trust deed loan to be obtained by Trustor prior to _____________, 20______.

3. The terms of the new first trust deed loan shall include:

3.1 A principal amount not to exceed $_______________.
3.2 An annual rate of interest not exceeding ______%.
3.3 Interest to accrue on the remaining balance at a ☐ fixed rate, or ☐ adjustable rate.
3.4 A term not less than ______ years, not more than ______ years.
3.5 Amortization of the loan payable monthly over _______ years, ☐ until paid, or ☐ with a final balloon payment due in not less than ______ years.
3.6 Origination fees and finance charges to be disbursed from the loan proceeds may not exceed ______ points and $_______________, respectively.
3.7 Other ____
____

4. ☐ Trustor shall use the net proceeds from this loan to improve the real property, both onsite and offsite. The primary construction to be ____
____
____
____

5. ☐ Trustor shall use the net proceeds from this loan to pay ____
____
____

6. Trustor shall receive $_______________ cash back from the loan proceeds.
These funds to be used for the following purpose(s) ____
____
____

7. ☐ **NOTICE: This subordination agreement contains a provision allowing the person obligated on your real property security device to obtain a loan, a portion of which may be expended on purposes other than improvements on the real property.**

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: __________________, 20______

Buyer/Trustor: ___________________________________

Buyer/Trustor: ___________________________________

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: __________________, 20______

Seller/Beneficiary: _______________________________

Seller/Beneficiary: _______________________________

The buyer claims anti-deficiency rules bar the carryback seller from collecting on the note since the seller's note was a purchase money obligation, created to finance the sale of the property.

However, the anti-deficiency rules no longer apply to the carryback note. The buyer and seller mutually agreed to a reconveyance of the trust deed to release the security.

The carryback seller can pursue the buyer to collect the balance due on the note since the security was released by mutual agreement.

To bar a seller from collecting on an unsecured carryback note — a note which is unsecured by mutual agreement between the seller and the buyer — would not advance the purposes of anti-deficiency rules. The buyer would be able to keep the property and pay less than the agreed-to price.

In contrast, a carryback trust deed note which becomes unsecured by mutual agreement is legally distinct from a carryback note which was **unsecured from the outset** of the sales transaction, even though both are recourse notes.

A seller who carries back an unsecured note on the close of a sales transaction has a *vendor's lien right* which he can impose on the property sold and judicially foreclose (if it is still owned by the buyer). The note was at all times unsecured and represents the amount of the purchase price remaining unpaid, contrary to the note held by the previously secured carryback seller. [Calif. Civil Code §3046]

In addition, a carryback seller or lender who requires a buyer to execute two notes for the **same debt**, one note secured by the real estate purchased, the other purportedly unsecured, is barred from collecting a deficiency. The underlying debt, evidenced in its entirety by each of the two notes, is secured by the property sold. Thus, the debt is a nonrecourse debt which can only be collected from the value of the property sold. [**Freedland** v. **Greco** (1955) 45 C2d 462]

Additional security

Now consider a lender who holds a purchase-money note. The debt is a purchase-assist loan secured by a first trust deed on owner-occupied, one-to-four unit residential property. Local real estate values have become depressed, causing the real estate to no longer be adequate security for the note.

The owner defaults on the note. To cure the default, the lender and owner mutually agree that:

- the terms of the note will be modified; and
- the owner will additionally secure the note by executing a trust deed to create a lien on another property owned by the owner.

Later, the owner defaults again. The lender judicially forecloses on both the owner's personal residence and the additional security, yet a deficiency in value still exists leaving the note unsatisfied.

Can the lender obtain a money judgment to collect the deficiency after judicially foreclosing on both the buyer's residence and the additional security?

Yes! Anti-deficiency rules do not bar the lender from a money judgment when a purchase-money note becomes **additionally secured** by other property. The note no longer is non-recourse, purchase-money paper. [CCP §580b]

However, a lender or carryback seller seeking a money judgment on recourse paper must concurrently foreclose on all of the secured properties in one judicial foreclosure action. No *piecemeal foreclosure sales* are allowed under a judicial foreclosure when multiple properties are the security and a deficiency judgment is sought. [CCP §726(a)]

SECTION G

Default and Foreclosure

Chapter 45 Notice of default, reinstatement, and redemption

This chapter analyzes what constitutes a default on a trust deed which allows the trust deed holder to initiate foreclosure, and an owner's reinstatement and redemption rights after his default.

Nullifying the call during foreclosure

A lender holding a trust deed and note may call the entire principal balance of the note due and immediately payable on any default in the terms of either the note or trust deed. Trust deeds contain a boilerplate provision called an *acceleration clause* that authorizes the lender to call the loan after a material default on the trust deed.

Another provision in the trust deed, called the *power-of-sale provision*, authorizes the beneficiary to instruct the trustee appointed under the trust deed to initiate a non-judicial trustee's foreclosure to sell the property described in the trust deed.

As a result of the tandem effect of the acceleration clause and the power-of-sale provision, the trustee's recording of a *notice of default* (NOD) both initiates the trustee's foreclosure procedures and causes all sums left to be paid on the note and trust deed to become due and immediately payable.

Consider a homeowner who defaults on the payment of principal and interest on the note and property taxes under the trust deed. An NOD is recorded, commencing foreclosure to enforce payment of all sums owed under.

An investor, aware of the NOD, submits a purchase agreement offer to the homeowner which is accepted. The terms include the transfer of ownership to the investor subject to the existing note and trust deed in foreclosure. The owner will pay all delinquencies and foreclosure charges at the close of escrow from equity purchase funds received from the investor.

Escrow is opened and the escrow agent sends a request for a beneficiary statement to the holder of the note and trust deed, called the *beneficiary*. The **beneficiary** is a private party who has commenced foreclosures before on this trust deed and canceled the NODs when the homeowner paid all the foreclosure costs and brought the delinquent payments and late charges current.

The beneficiary responds to escrow's request for a beneficiary statement by sending a payoff demand, not a beneficiary statement. The beneficiary claims he is enforcing the acceleration clause in the trust deed and will only accept payment in full now that the NOD has been recorded, triggering the call.

The NOD states the **amount of the delinquencies**, past, present, and future. Thus, escrow is able to determine the amount due to cure the defaults stated in the NOD. The trustee is contacted and the total of the foreclosure fees and charges incurred by the date scheduled for close of escrow are determined.

The investor deposits closing funds with escrow on escrow's call for funds. Escrow is closed and the delinquencies and foreclosure costs are forwarded to the trustee, payable to the beneficiary in the form of the homeowner's sales proceeds.

The beneficiary rejects the sales proceeds, claiming the entire amount of his note is due as agreed in the trust deed. Further, the beneficiary claims the due-on clause in the trust deed has been triggered by the buyer's failure to obtain the beneficiary's consent to the sales transaction and now requires a full payoff of the note.

Can escrow, by tendering only the amount of the delinquencies and foreclosure costs necessary to cure the defaults, cause the note and trust deed to be brought current and reinstate the trust deed as though a default had not occurred?

Yes! After the NOD has been recorded and prior to five business days before the trustee's sale, the owner (or any junior lienholder or buyer) of the real estate encumbered by the trust deed lien that is in foreclosure can terminate the foreclosure proceedings by paying:

- the delinquent amounts due on the note and trust deed as described in the NOD and foreclosure charges, called *reinstatement* [Calif. Civil Code §2924c]; or

- the entire amount due on the note and trust deed, plus foreclosure charges, called *redemption*. [CC §2903]

Since the call triggered by a violation of the due-on clause based on the unconsented-to transfer to the investor is not stated in the NOD, the due-on call cannot be enforced under this NOD.

Monetary defaults and reinstatement

A trust deed on which a foreclosure has been initiated is considered reinstated when the beneficiary receives:

- all amounts referenced as delinquent in the NOD, including principal, interest, taxes, insurance, assessments, and advances;

- installments that become due and remain unpaid after the recording of the NOD, and any future advances made by the beneficiary after the recording of the NOD to pay taxes, senior liens, assessments, insurance premiums, and to eliminate any other impairment of the security; and

- costs and expenses incurred by the lender to enforce the trust deed, including trustees fee's or attorney fees. [CC §2924c(a)(1)]

After an NOD is recorded, an owner or junior lienholder of an interest in the real estate in foreclosure can bring current any monetary or curable default stated in the NOD prior to five business days before the trustee's sale, called the *reinstatement period*. If the sale is postponed, the reinstatement period is extended, ending the day before the five business days prior to the postponed sale date. [See Figure 1; CC §2924c(e)]

Until the NOD is recorded by a trustee, the tender of all delinquencies must be accepted by the beneficiary.

After recording the NOD, the lender's trustee must allow three months (not 90 days) to pass before advertising and posting notice of the date of the trustee's sale. [CC §2924; see Figure 1]

The lender's trustee must begin advertising and post a Notice of Trustees Sale (NOTS) – and any other related notices – at least 20 days before the date of the sale. The property can be sold by the trustee no sooner than the twenty-first day after advertising begins and the posting of notice occurs. [CC §2924f(b); see Figure 1]

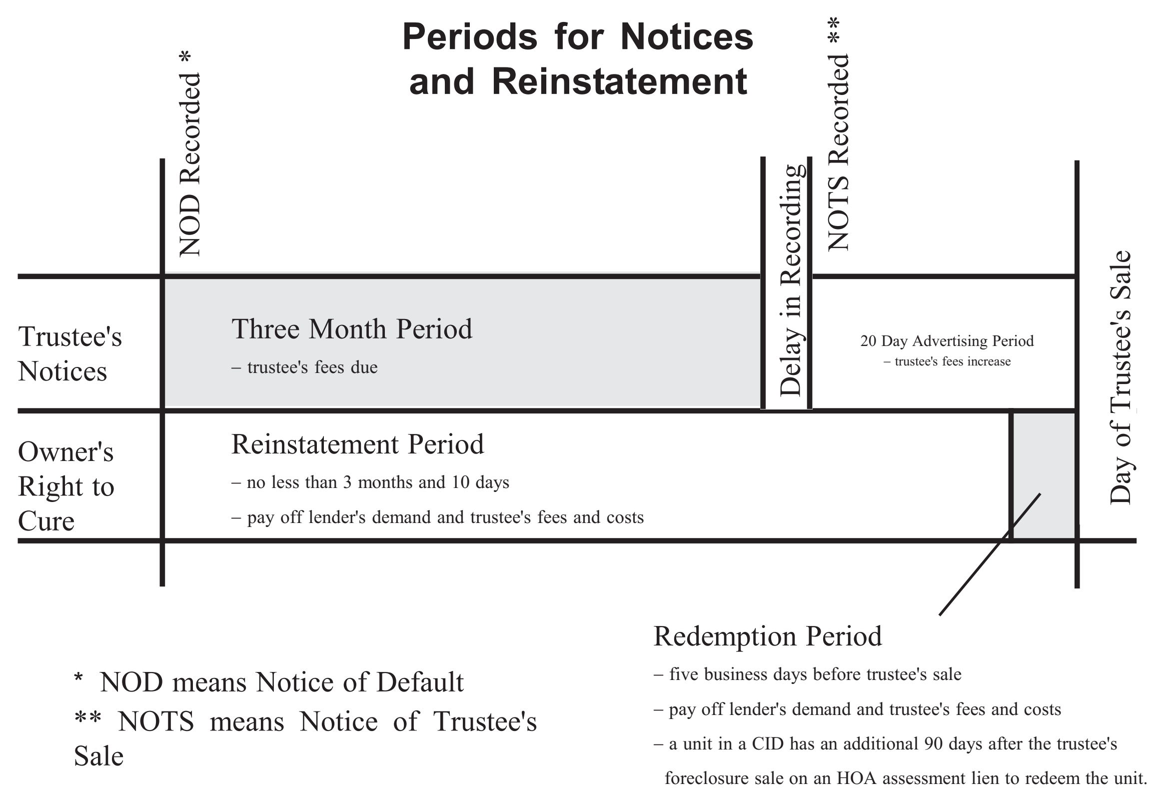
Additionally, if the billing address for the borrower is different than the address of the residential property in foreclosure, the NOTS must be accompanied by a notice to the occupants regarding their rights during and after foreclosure. [CC §2924.8]

The owner in foreclosure is not allowed to delay the trustee's sale by requesting a postponement. [CC §2924g]

Thus, the owner, or junior lienholder, has a minimum of approximately 105 days after the recording of the NOD to cure the default and reinstate the note and trust deed to avoid a full payoff or foreclosure sale of the property.

To determine the last day for reinstatement of the note and trust deed, consider a trustee's sale that is scheduled for a Friday. Count back five business days beginning with the first business day prior to the scheduled Friday sale. Since weekends are not business days, the fifth day counting backward from the scheduled trustee's sale is the previous Friday (if no holidays exist).

Figure 1



Thus, the very last day to reinstate the loan is on the Thursday eight calendar days before the trustee's sale.

The lender's failure to identify or include the dollar amount of all known defaults in the NOD does not invalidate the NOTS. Further, the lender can enforce payment of any omitted defaults by recording another, separate NOD. [CC §2924]

On reinstatement of the note and trust deed, the NOD is rescinded by the trustee, removing the recorded default from the title of the property. [CC §2924c(a)(2)]

Any call is eliminated and the loan is returned to installment status when the note and trust deed have been reinstated. Upon reinstatement, the owner continues his ownership of the property as though the loan had never been in default.

Redemption

Failure to cure a default before the reinstatement period expires allows a trust deed holder to require the owner to redeem the property and avoid the trustee's sale by:

- paying all sums due under the note and trust deed; and
- reimbursing the costs of foreclosure prior to completion of the trustee's sale.

The owner's right of redemption exists until the trustee completes the bidding and announces the property has been sold. Any owner, junior lienholder, or other person with an interest in the property may satisfy the debt and redeem the property prior to the completion of the trustee's sale. [CC §2903]

To redeem the property, the owner or junior lienholder is required to pay the principal and all interest charges accrued on the principal, permissible penalties, foreclosure costs, and any future advances made by the foreclosing lender to protect his security interest in the property.

Unless all amounts due on the note and trust deed resulting from the owner's default are paid in full during the redemption period, the owner will lose the property at the trustee's foreclosure sale.

Lender remedies on a default

An owner's default on a trust deed loan encumbering his property can arise under a provision in either the note or the trust deed. A default on the note triggers a default on the trust deed, permitting foreclosure.

When the owner fails to pay installments of principal and interest as they become due under the terms of the note, he is then in **default** on the note. Thus, a default also exists on the trust deed.

The owner's default prompts the trust deed noteholder to immediately call the loan due under the **acceleration clause** in the note and trust deed by recording a NOD that initiates a trustee's foreclosure sale.

Additionally, when the owner fails to meet his obligations regarding the care, use, and maintenance of the secured real estate, he is in default under the *waste provision* in the trust deed. The default on the trust deed exists even though the owner may be current on all payments and the note is not in default.

The owner's failure to pay property taxes, hazard insurance premiums, assessments, and amounts due on senior trust deed liens is considered a default on the trust deed.

The owner's alternatives

Aside from reinstatement and redemption, an owner of property has several other options when faced with losing his property through foreclosure:

1. *Refinance* — The owner obtains a new loan to pay off the one in default.

2. *Foreclosure consultant* — The owner seeks the services of a financial advisor or investment counselor, called a **foreclosure consultant**. For a fee, a foreclosure consultant will:

- prevent a lender from enforcing or accelerating the note;
- help the owner reinstate the loan or receive an extension of the reinstatement period; or
- arrange a loan or an advance of funds for the owner. [CC §2945.1(a)]

However, a property owner grappling with foreclosure can obtain similar services at no cost from a *mortgage counselor* subsidized by the federal government.

3. *Deed-in-lieu* — The owner deeds the property directly to the lender in exchange for cancelling the secured debt. [See Chapter 50]

4. *Litigate* — The owner disputes the validity of the foreclosure by filing an action, restraining and enjoining the foreclosure.

5. *Bankruptcy* — The owner files for bankruptcy protection which automatically stays the foreclosure until a release of the stay is obtained by the lender from the court. [11 United States Code §362(a)]

Unless the owner can make up the default or have the loan amount "crammed down" as part of the reorganization plan, bankruptcy only delays the inevitable foreclosure. Once the automatic stay is lifted, the foreclosure sale may take place no sooner than seven calendar days later. [CC §2924g(d)]

6. *Sale* — The owner sells the property before the trustee's sale.

A recorded notice of default (NOD) must state the owner has the right to sell his property which in foreclosure. [CC §2924c(b)]

In an effort to protect owners from being unlawfully deprived of the equity in their property when selling the property during the foreclosure period, special requirements exist for purchase agreements between owners and **equity purchase investors** on owner-occupied, one-to-four unit residential property in foreclosure. [CC §1695 et seq; see Chapter 46]

However, selling property in foreclosure is difficult for the owner, due to time constraints and the difficulty of finding a buyer able to meet the financing needs to assume existing loans, cure defaults and correct the deferred maintenance on the property.

7. *Walk* — The owner simply vacates the property when the lender completes foreclosure.

This is an economically viable alternative for an owner with little or no cash investment in the property, especially if payments saved during continued occupancy exceed the cash invested and the loan balance exceeds the property's value.

A trust deed noteholder may advance funds to cure a default on the trust deed, such as the owner's failure to pay hazard insurance premiums, and then add the advance to the debt owed by authority of the trust deed's **future advances** provision. The trust deed noteholder may then demand the immediate repayment of the advance from the owner.

Let the grace period run before NOD

Consider a trust deed note held by a carryback seller that calls for installments to be paid by the first day of each month. A provision in the note imposes a late charge when the monthly installments are not received within 10 days after the installment's due date.

The seller consistently receives installments within the 10-day period after the installments become due, but never by the due date itself. Eventually, the carryback seller gives the buyer reasonable advance notice (30 days) that the installment for the following month must be paid by the first day of the month, the payment's actual due date. If it is not paid by the first, the seller advises the buyer he will begin foreclosure proceedings by recording a NOD.

The following month, the buyer fails to deliver the installment by the first. The carryback seller records an NOD beginning foreclosure proceedings within the 10-day no-charge period.

The payment is received by the seller within 10 days after the due date.

The seller claims the monthly installment was delinquent since it was not paid by the first day of the month, thus placing the buyer in default on the second day of the month.

The buyer claims a default did not exist when the NOD was recorded since the NOD was recorded prior to incurring the agreed-to late charge.

Can the carryback seller begin foreclosure proceedings for the past-due monthly installment before the late charge is incurred?

No! The payment, while due, is not yet considered delinquent due to the existence of the late charge provision. Foreclosure proceedings may not be initiated for a past due payment during the period before a late charge is incurred. When a note provision imposes a late charge on the expiration of a specified time period without receipt of the amount due, this extended time for payment without penalty qualifies as a *grace period*.

Since a **grace period** exists, a foreclosure may not be initiated to enforce payment of the installment until after the grace period runs, when the payment becomes delinquent if unpaid. [**Baypoint Mortgage Corporation** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

Trust deed defaults and reinstatement

A property owner's ability to **reinstate** a loan by curing a default under a trust deed provision relating to the property and its title depends on the trust deed provision in default.

For example, an owner of real estate encumbered by a trust deed fails to pay property taxes or keep other senior liens on the property current. The trust deed lender records an NOD, describing the delinquent property taxes and other senior liens as the owner's default under the trust deed.

Can the property owner reinstate the loan and retain the property by eliminating the default?

Yes! The default is monetary, entitling the owner to reinstate the loan by simply paying the delinquent property taxes and payments on the senior lien, and the trustee's fees and charges incurred in the foreclosure proceeding.

Also, monetary defaults on trust deed provisions, such as the owner's failure to pay assessments, ground lease rent, senior encumbrances, hazard insurance premiums, or to obtain a hazard insurance policy, may be cured and the loan reinstated on the owner's tender of the full dollar amount of the default. [CC §2924c]

Defaults cured only by redemption

Some trust deed defaults do not allow an installment debt to be reinstated. Reinstatement of the note on those defaults is only available if agreed to by the lender. Defaults triggering a call and requiring redemption of the property by a payoff of the entire debt include a breach of a due-on clause, a waste provision, or a violation of law provision in the use of the property.

Consider real estate that is encumbered by a trust deed that requires the owner to maintain his property in good condition and repair. The owner fails to repair the aging improvements on his property and allows the trees and lawn to die.

The trust deed lender becomes concerned since the owner's activities causing waste have decreased the value of his security, called *impairment*. Due to the owner's failure to maintain the property in good condition (and thus the loan-to-value ratio due to a reduced property value), the lender records an NOD against the property.

Unlike a failure to maintain hazard insurance, here the owner cannot cure the default in the trust deed (waste) by tendering less than the entire remaining balance of the debt. Thus, the owner is unable to reinstate the loan. As a result, the entire foreclosure period becomes the redemption period.

To retain ownership of the property after the loan had been called due to waste, the owner must **redeem** the property by tendering full payment of all sums due, including foreclosure costs, prior to the trustee's sale.

Alternatively, the trust deed gives the lender the authority to cure the waste and add that cost to the principal balance of the note under the future advances clause.

However, when waste by the owner is committed in bad faith, the foreclosing lender must consider an underbid in a dollar amount equal to the property's reduced fair market value should the lender acquire the property at the trustee's sale. With an underbid, the lender can sue the owner to recover the deficient property value below the amount due, which was caused by the bad faith waste, even if the note is a nonrecourse debt. [**Cornelison** v. **Kornbluth** (1975) 15 C3d 590]

Chapter 46 Judicial foreclosure

This chapter outlines the judicial foreclosure process, and presents the rights exercisable by property owners and junior lienholders before and after a judicial foreclosure sale.

Deficient property value; recourse paper

When a trust deed note is in default, the trust deed lender's **collection efforts** are limited to two activities: judicial or non-judicial, both of which are very structured. If the note evidences a **recourse debt**, the lender may elect to recover against both the property and the borrower or just the property.

To initiate either type of collection effort, a trust deed lender must first *exhaust the security* by foreclosing on the real estate described in the trust deed lien. The lender's security interest in a property is exhausted when the lender **forecloses** on the property or when the lender's trust deed is **wiped out** by a senior trust deed holder's foreclosure.

Only when the note evidences a **recourse debt** may the lender pursue a money judgment against the signers on the note for any deficiency in the property's value to fully satisfy the debt owed. [Calif. Code of Civil Procedure §726]

Foreclosure is an activity comprised of notices and an auction to sell real estate to satisfy a debt secured by the security interest held in the property by the lender. Foreclosure of the property eliminates the *right of redemption* held by the owner and any persons holding junior interests in the property.

A trust deed holder can **foreclose** on a property, which is the security for a note, in one of two ways:

- *judicial foreclosure*, under mortgage law, also called a *sheriff's sale* [CCP §725a]; or
- *nonjudicial foreclosure*, under the power-of-sale provision in the trust deed, also called a *trustee's sale*. [Calif. Civil Code §2924]

Judicial foreclosure is the court-ordered sale by public auction of the secured property. The process can last from eight months to multiple years before it is completed.

When a trust deed holder **nonjudicially forecloses** by a trustee's sale, the property is sold by private agreement at a public auction. Trustee's sales can be completed on property other than a one-to-four unit residential property within four months after a buyer defaults. Unlike a judicial foreclosure sale, the completion of a trustee's sale denies the foreclosing lender the opportunity to obtain a money judgment for any unpaid balance remaining on the note after the foreclosure sale due to an *underbid* and *insufficient value* in the secured property. [CCP §580d]

Trustee's sales are considerably less expensive than judicial foreclosures, both in time and money. A judicial sale requires the filing of a lawsuit which includes litigation expenses, appraisals, attorney fees, and a greater length of time then would be required for a nonjudicial foreclosure. [See Chapter 51]

However, when the value of a secured property drops below the balance owed on a *recourse debt*, the lender must consider foreclosing by judicial action, whether or not he ultimately chooses to do so.

A judicial foreclosure, or sheriff's sale, is the only foreclosure method which allows a lender to obtain a money judgment against the borrower for any deficiency in the value of the secured property to fully satisfy a recourse debt. [CCP §580d]

Editor's note — The source of recovery on a default in a trust deed securing a purchase-money debt is limited to the value of the secured property. ***Purchase-money debts*** *include:*

- *carryback notes secured solely by the real estate sold; and*
- *purchase-assist loans secured by buyer-occupied, one-to-four unit residences.*

Anti-deficiency rules preclude a buyer's personal liability for any purchase-money debts. [CCP §580b]

Thus, a carryback seller secured solely by the property sold and a purchase-assist lender secured by a buyer-occupied, one-to-four unit residential property have nothing to gain but much to lose by foreclosing judicially. [See Chapter 43]

Suing to foreclose

As with any lawsuit, the first step in a judicial foreclosure is the filing of a complaint in the Superior Court of the county where the property is located.

The foreclosure complaint must name as defendants the **original borrower** and anyone else holding a recorded interest in the secured property which is junior to the foreclosing lender's trust deed lien. The trustee named in the trust deed does not need to be involved in the lawsuit in any way. A trustee under a trust deed has no interest in the property, is unconcerned wit hthe judicial foreclosure, and thus it is not necessary for him to be involved in the judicial proceedings.

The lender foreclosing judicially must obtain a *litigation guarantee* of title insurance. The policy is comparable to a trustee's guarantee ordered out to assist a foreclosure trustee in the notice process.leading to the auction sale of the property.

The **litigation guarantee** lists all parties with a recorded interest in the property and their addresses of record. The litigation guarantee ensures that persons with a recorded junior interest in the property are named and served, so their interest is eliminated from title by the judicial foreclosure sale.

If a person holding an interest in the propert junior to the lender's trust deed is not named as a defendant:

- his lien is not affected by the outcome of the foreclosure proceedings; and
- his lien on the property being foreclosed remains of record. [CCP §726(c)]

Consider an adjacent property owner who holds an easement and water rights in a parcel of real estate which are subject to a prior trust deed lien. The grant of his easement and water rights occurred after the trust deed was recorded.

The trust deed holder judicially forecloses and acquires the property but fails to name and notify the easement holder of the foreclosure action and judicial sale.

The trust deed holder now seeks to extinguish the easements and water rights held by the easement holder in a separate judicial foreclosure action on the same trust deed lien.

The easement holder claims his rights cannot now be extinguished since the senior trust deed holder already completed a foreclosure and became the owner of the property, and thus no longer holds an interest in the property which has priority to the easement.

Can the senior trust deed holder judicially foreclose again under the same trust deed lien to extinguish the owner's easements and water rights?

Yes! Having already completed a judicial foreclosure, the trust deed holder can later foreclose by another judicial foreclosure action to extinguish the previously omitted junior easements and water rights. However, the junior easement holder retains the same right of redemption (for one year) he would have had in the first foreclosure action had he been named. [**Diamond Benefits Life Insurance Company** v. **Troll** (1998) 66 CA4th 1]

Additionally, when the foreclosing lender intends to seek a deficiency judgment, the original borrowers must be named as defendants, whether or not the borrowers still hold an interest in the property. [**Hutchison** v. **Barr** (1920) 183 C 182]

At the time the lawsuit is filed, the foreclosing lender records a **Notice of Pending Action** against the secured property, called a *lis pendens*.

The **lis pendens** places a cloud on the title of the secured property, giving notice of the judicial foreclosure action and subjecting later acquired interests by buyers, tenants or lenders to the results of the litigation without their being named or served with a lawsuit.

After recording the lis pendens, the title company issuing the litigation guarantee is asked to *date down* the policy through the recording date of the lis pendens to discover any intervening recordings which might affect the proceedings, such as federal tax liens.

Reinstatement

Until the court enters a judgment ordering the sale of the secured property, called a *foreclosure decree*, the borrower has the right to bring the delinquencies in the note and trust deed current. A foreclosure decree brings to an end the period of time called the *reinstatement period*.

The borrower or any holder of an interest in the property junior to the foreclosing lender's security interest may **reinstate** the loan prior to the foreclosure decree by tendering payment of:

- the loan delinquencies;
- accrued interest; and
- the lender's foreclosure costs such as litigation expenses. [CC §2924c]

If the borrower reinstates the delinquent debt, a right enforceable until the court's entry of the foreclosure decree, the lender must abandon its foreclosure attempt and dismiss the lawsuit.

Attorney fees due on a reinstatement are limited in amount by statute. [See Chapter 51]

The junior lienholder

Before entry of a judicial foreclosure decree, a junior trust deed holder or other lienholder may **reinstate** the note by paying the trust deed delinquencies and foreclosure costs, bringing the trust deed note current.

After entry of a **foreclosure decree** ordering the property to be sold, the junior lienholder has until the time the property is sold at the foreclosure sale to **redeem** the property by paying all amounts owed on the debt and foreclosure costs. [CC §2903 et seq.]

Once a property is sold at a judicial foreclosure sale, any liens subordinate to the foreclosing lender's trust deed are wiped out and eliminated from the title. [CCP §§701.630; 729.080(e)]

If the junior lienholder does not reinstate the note or purchase the property at the judicial foreclosure sale, and the owner later **redeems the property**, the junior lienholder will then be able to recover the amount of his lien, plus interest. [CCP §729.060(b)(5)]

A creditor holding an unrecorded lien not actually known to the foreclosing lender does not need to be named or notified of the judicial foreclosure action to have the unrecorded lien extinguished on completion of a recorded lienholder's judicial foreclosure sale. [CCP §726(c)]

Editor's note — If the junior lienholder of record is unnamed or unserved in a judicial foreclosure action by the senior trust deed holder, the junior trust deed holder still has an enforceable trust deed after the first trust deed lender's judicial foreclosure sale.

*Unaffected by the judicial foreclosure for lack of notice, and the lender being time barred from filing another judicial foreclosure action, the junior trust deed holder may initiate his own judicial or trustee's foreclosure proceedings to enforce his trust deed. The junior trust deed holder's interest would be senior to the interest of the high bidder at the first's judicial foreclosure sale. [**Little** v. **Community Bank** (1991) 234 CA3d 355]*

Consider a wiped-out junior trust deed holder whose note evidences a **recourse debt**. The junior lienholder whose security interest in the property has been exhausted sues to collect the debt from the owner who executed the note. Accordingly, the junior lienholder obtains a money judgment on the note since his trust deed has been eliminated and he cannot foreclose on the property.

With a money judgment replacing the now unsecured note, the junior lienholder records an *abstract of judgment.* The recorded **abstract of the money judgment**:

- creates an involuntary lien on all properties vested in the name of the owner; and
- replaces the trust deed note, evidencing a different debt (the money judgment) with different rights than the debt owed under the trust deed.

Should the owner redeem the property, the junior trust deed holder has a lien on the property which he can foreclosure. The junior lienholder can also proceed with a **sheriff's sale** to collect on the money judgment by a foreclosure on other properties which were attached by the recorded abstract. [**O'Neil** v. **General Security Corporation** (1992) 4 CA4th 587]

However, consider a junior lienholder with a recourse debt who postpones his trustee's foreclosure proceedings on the commencement of the senior lienholder's foreclosure and is later wiped-out. The wiped-out junior lienholder may seek a money judgment and is not barred because he started, but did not finish, his foreclosure. [**Bank of America National Trust and Savings Association** v. **Graves** (1996) 51 CA4th 607]

The foreclosure decree

A lender judicially foreclosing on real estate establishes its right to collect the debt and sell the secured property by obtaining a *foreclosure decree* at a summary judgment proceeding or a trial.

A **foreclosure decree** orders the sale of the real estate to satisfy the outstanding debt and cover foreclosure sale expenses incurred by the lender. [CCP § 726(a), (b)]

The foreclosure decree also states whether the borrower will be held personally liable for any deficiency in the property's fair market value to satisfy the debt owed. [CCP §726(b)]

The recovery of attorney fees must be accounted for in the foreclosure decree. Attorney fees incurred after the foreclosure decree are not included in the amount required to redeem the property. [**Hambrose Reserve, Ltd.** v. **Faitz** (1992) 9 CA4th 129]

Notice of Levy

A judicial foreclosure sale is conducted by a court-appointed receiver or sheriff, called a *levying officer*.

After the judicial foreclosure sale is ordered by the court, the foreclosing lender is issued a *writ of sale* by the court clerk which authorizes the receiver or sheriff to record a *notice of levy*. The **writ of sale** and the **notice of levy** describes the property to be sold and states the levy is against the security interest the lender holds in the property under his trust deed lien. [CCP §712.010]

The receiver or sheriff who conducts the sale **records** the writ of sale and the notice of levy in the county in which the property is located. [CCP §700.015(a)]

The receiver or sheriff also mails to the owner, and serves on any occupant of the property, the writ of sale and the notice of levy. [CCP §700.010]

The notice of judicial sale

Similar to the notice of trustee's sale used in a nonjudicial foreclosure, the receiver's or sheriff's notice of sale must state the necessary details as to the date, time and location of the auction sale. [CCP §701.540(a)]

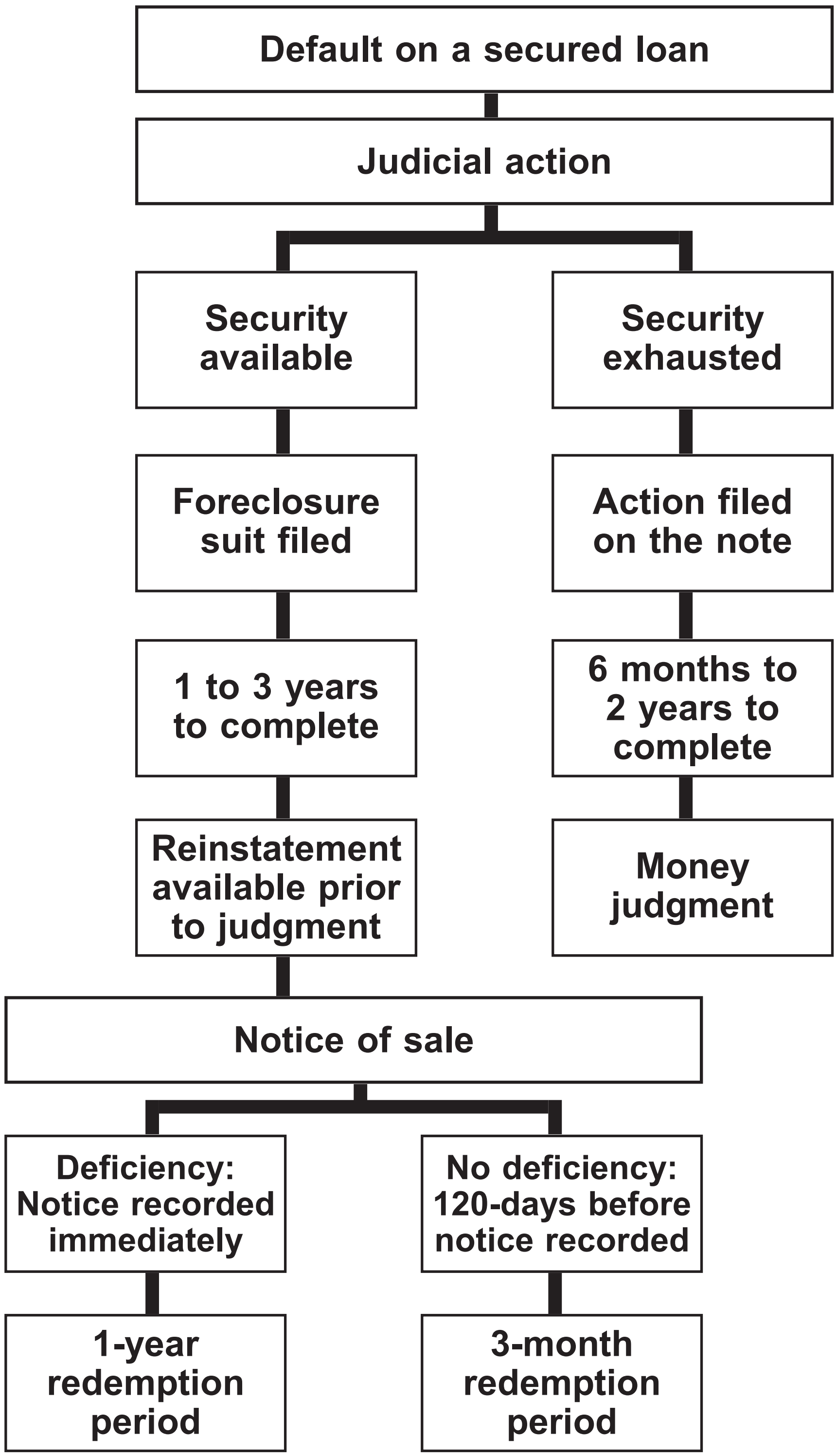
When a deficiency judgment is sought by a lender, the notice of judicial sale also states:

- the property is being sold subject to the borrower's right of redemption; and
- the amount of the secured debt, plus accrued interest and foreclosure costs. [CCP §729.010(b)(1)]

If a money judgment for any deficiency is prohibited, as occurs with a non-recourse debt, the receiver or sheriff must wait at least 120 days after service of the notice of levy before he may notice the judicial sale. [CCP §701.545]

However, if the lender seeks a deficiency judgment, no waiting period applies for noticing the sale. The receiver or sheriff may notice the judicial sale immediately after the decree is issued. [CCP §729.010(b)(2), (3)]

Collecting a recourse debt



At least 20 days before the sale, the notice of judicial sale is:

- served on the borrower personally or by mail [CCP §701.540(c)];
- mailed to any person who has recorded a request for a notice of judicial sale [CCP §701.550(a)];
- posted in a public place in the city or judicial district where the property is located, and on the property itself; and
- published weekly in a local newspaper of general circulation. [CCP §701.540(g)]

Highest bidder acquires the property

The public sale held by a court-appointed receiver or sheriff is conducted as an auction. The property is **sold to the highest bidder**. [CCP §701.570]

Payment at the public sale must be made in cash or by certified check at the time of the sale. However, amounts over $5,000 permit a credit transaction. [CCP §701.590(a), (c)]

If the successful bidder fails to pay the amount bid, the receiver may sell the property to the highest bidder at a subsequent sale. The defaulting bidder is liable for interest, costs and legal fees for his failure to pay his bid. [CCP §701.600]

Often, the foreclosing lender is the highest, or only, bidder at a judicial sale. When intending to seek a deficiency judgment, the lender must **bid no less** than an amount it believes the court will set as the *fair market value* (FMV) of the property. If he allows the property to be bid in at the sale for less than its FMV, the lender incurs an uncollectible loss for the difference. [**Luther Burbank Savings & Loan Assn.** v. **Community Construction, Inc.** (1998) 64 CA4th 652]

Judicial sale completed

A *certificate of sale* is issued to the successful bidder on the completion of a judicial sale.

Although the bidder purchased the property at the public auction, he will not become the owner of the property or be able to take possession of it by removing the owner until the applicable **redemption period** expires. [CCP §729.090]

The **certificate of sale** reflects the owner's continuing right to redeem the property and avoid losing it to the highest bidder. [CCP §729.020]

Redemption follows foreclosure

On a judicial foreclosure, a trust deed which secures a seller carryback note as a lien solely on the property sold, or a lender's purchase-assist loan as a lien on a buyer-occupied, one-to-four unit residence, the property owner:

- is not liable for any deficiency in the property value to fully satisfy the debt [CCP §580b]; and
- has **three months** after the judicial sale to redeem the property by paying off the entire debt and costs. [CCP §729.030]

However, if the owner is liable on a recourse debt for a deficiency in the property's value, the owner has up to **one year** after the judicial sale to redeem the property. [CCP §729.030]

The property can only be redeemed by the owner or the owner's *successor-in-interest* since all junior lienholders are wiped out by the judicial foreclosure sale, ending their period for redemption.

Successors-in-interest to the owner are lienholders or buyers who acquire the owner's interest in the property by deed prior to the judicial foreclosure sale. [CCP §729.020; 15 Calif. Law Revision Commission Reports 2001]

For example, a junior lienholder holds a trustee's foreclosure sale and bids in the property and receives a trustees deed **prior to completion** of the senior lienholder's judicial foreclosure sale. Since the junior lienholder owns the property at the time of the judicial foreclosure sale, he is considered the owner's successor-in-interest.

As the successor-in-interest to the owner, the junior lienholder is entitled to redeem the property after the senior lienholder's later judicial foreclosure sale, subject to the redemption period rights which are available only to the owner. [CCP §729.020]

The successful bidder who purchases the property at the judicial foreclosure sale is not considered the owner's successor-in-interest, but is the **creditor's successor** until the end of the redemption period. [CCP §729.020]

The **redemption price** for the owner (or successor) to recover the property sold at a judicial foreclosure sale is the total of:

- the price paid for the property by the highest bid at the judicial foreclosure sale;
- taxes, assessments, insurance premiums, upkeep, repair or improvements to the property paid by the successful bidder; and
- interest on the above amounts at the legal rate on money judgments (10%) from the date of the payments through the date the redemption amount is tendered in full. [CCP §729.060]

On **redemption**, the owner or his successor is entitled to:

- an offset for any net rents collected by the lender under an **assignment of rents provision** in the trust deed; and
- an offset for the rental value of the premises for any period of time the successful bidder occupied the property following the sale. [CCP §§729.060, 729.090]

If the property is not redeemed by the owner or his successor-in-interest within the owner's redemption period, the receiver issues the bidder a *sheriff's deed* to the property, and the sale is final. [CCP §729.080]

Obtaining a deficiency judgment

The remaining balance owed on a note may be greater than the *fair price* of the lender's security interest in the real estate. The spread when the fair price is higher is the *deficiency* in the value of the property to cover the debt. The **fair price** of the lender's position in title is based on the value of the property at the time of the judicial foreclosure sale.

A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by anti-deficiency statutes. The lender will be awarded a money judgment for any deficiency in value at a hearing following the foreclosure sale. At the post-foreclosure hearing, the amount of the deficiency is set by the court — the difference between the fair price of the lender's security interest in the property on the date of the judicial foreclosure sale and the amount of the debt — called a *fair value hearing*. [CCP §§580a, 580b]

A **fair value hearing**, noticed within three months after the foreclosure sale, will set the dollar amount awarded as a deficiency judgment. [CCP §§580a, 726(b)]

The amount awarded as a deficiency judgment is based on the debt owed under the note and trust deed on the date of the judicial foreclosure sale, and the greater of:

- the FMV of the property on the date of the foreclosure sale, minus any amounts owed on liens senior to the trust deed being foreclosed, the result setting the *fair price* of the lender's security interest; or

- the amount **bid** for the property at the judicial foreclosure sale. [CCP §580a]

The lender will be awarded a money judgment for the portion of the debt not covered by the fair price of the lender's secured position on title or the price bid at the sale, which ever amount is higher.

The lender and the borrower present evidence at the fair value hearing to establish the property's FMV. The court may appoint an appraiser, called a *probate referee*, to advise the court on the property's FMV. Thus, evidence consists of the opinions of appraisers (and the owner) about the FMV of the property on the date of the sale. [CCP §§580a, 726(b)]

The formula for a deficiency

Consider a lender who judicially forecloses on the security interest it holds in real estate under a first trust deed lien securing a recourse debt. The property is encumbered by unpaid property taxes, a lien which has priority to the lender's trust deed which the lender has not paid.

At the foreclosure sale, the lender acquires the real estate, subject to the property tax liens. The lender's credit bid is for less than the amount owed on the debt, called an *underbid*. Also, the bid is for less than the *fair price* of the lender's security interest in the property on the date of the foreclosure sale.

At the **deficiency hearing**, the lender is awarded a money judgment calculated as the unpaid amount due the lender less the fair price of the equity under thetrust deed securing the lender's loan on the date of the foreclosure sale (not the amount of the underbid), **plus** the unpaid property taxes.

Within one year after the foreclosure sale, the owner redeems the property for the amount of the underbid entered by the lender, plus interest on that amount from the date of the foreclosure sale.

The redemption amount owed by the owner to recover his property is less than the fair price the court set for the lender's security interest to determine the deficiency owed to the lender. When the lender bids less than the total amount of the debt owed and that bid is also less than the fair price of the lender's trust deed interest in the property, the underbid sets only the redemption price, not the deficiency. As a result, the difference between the lesser amount of the underbid and the greater fair price of the lender's security interest becomes an unrecoverable loss for the lender. The owner both redeemed the property and paid the money judgment, two amounts which do not come up to the FMV of the property.

However, the property is still encumbered by the unpaid property taxes.

The owner claims the unpaid property taxes were improperly added to the deficiency judgment and he will incorrectly have to pay them twice:

- once when the unpaid taxes were added into the amount of the deficiency judgment awarded to the lender; and

- again as a lien which remains on the property the owner redeemed.

Here, the amount set as the deficiency is correct, although the mathematical approach used by the court was not. The trust deed lender's **secured position** on title to the property was subject to property taxes.

Thus, the dollar amount of unpaid taxes (and any other liens with priority) must first be deducted from the property's FMV to set the **fair price** of the lender's interest in the property.

Only after establishing the fair price of the lender's secured position can the amount of the fair price be deducted from the total debt and costs owed the lender to determine the deficiency. That deficiency becomes the amount of the money judgment. [**Luther Burbank Savings and Loan Association** v. **Community Construction, Inc.** (1998) 64 CA4th 652]

The **correct formula** for calculating the deficiency (always a negative amount): **Enter** the FMV of the property, **subtract** both the unpaid tax liens and any other prior liens and the remaining debt owed the foreclosing lender. The result, if negative, is the amount of the deficiency awarded to the lender.

The fair price

A deficiency judgment is awarded to a lender based on the **unencumbered full cash value** of the secured property, a value which is set consistent with current market conditions on the date of the foreclosure sale, called *fair market value* (FMV). [CCP §726]

Clouds on title, such as a junior lien or a lis pendens, which are wiped out at a foreclosure sale do not affect the property's FMV. [**Nelson** v. **Orosco** (1981) 117 CA3d 73]

Editor's note — However, a federal tax lien with a 120-day right of redemption may reduce the price a buyer would pay for the lender's position in the title since the price paid is the amount the Internal Revenue Service (IRS) would pay the buyer to acquire the property.

The bid accepted at the judicial foreclosure sale is not considered when setting the property's FMV. [**Rainer Mortgage** v. **Silverwood, Ltd.** (1985) 163 CA3d 359]

The FMV of property is set without concern for any negative impact the foreclosure sale may have had on the property's value, or the price a prudent buyer would have to pay at the foreclosure sale for the lender's security position on title. [**San Paolo U.S. Holding Company, Inc.** v. **816 South Figueroa Company** (1998) 62 CA4th 1010]

Once the FMV of the property is determined, the amount of the deficiency is determined by subtracting all prior lien amounts and the amount of the debt being foreclosed from the property's FMV.

If the amount remaining is negative, the lender is awarded a deficiency judgment for that negative amount. Thus, any underbid below the fair price for the lender's position in the property results in a loss for the lender. The amount of the difference between the fair price of the lender's position and the underbid is not recoverable in either the deficiency judgment or on redemption by the owner.

Chapter 47 Trustee's foreclosure procedures

This chapter discusses a trustee's statutory duties for publicly conducting a privately agreed-to foreclosure sale of real estate.

Power-of-sale provision

A lender or carryback seller holding a note secured by a trust deed which is in default has **two foreclosure methods** available to enforce collection of the secured debt:

- a *judicial foreclosure sale*, also called a *sheriff's sale* [Calif. Code of Civil Procedure §726]; or
- a *nonjudicial foreclosure sale*, also called a *trustee's sale*. [Calif. Civil Code §2924]

The key to the trust deed holder's ability to **nonjudicially foreclose** by a trustee's sale on the secured real estate is the *power-of-sale authority* and *power-of-sale provision* contained in the trust deed. [See Figure 1]

Other security devices used to create a lien on real estate to secure a debt which may also contain a **power-of-sale provision** include:

- a land sale contract [**Petersen** v. **Hartell** (1985) 40 C3d 102; see Form 165 §15 in Chapter 35];
- a lease-option sale [See Form 163 §19 in Chapter 35];
- a UCC-1 financing statement [**Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25]; or
- the conditions, covenants and restrictions (CC&Rs) of an association for collection of assessments. [CC §1367]

The grant of the power-of-sale provides a private contract remedy for the **recovery of money**, voluntarily agreed to by the owner of the secured property, authorizing the secured creditor on a default in the trust deed to hold a nonjudicial foreclosure sale by public auction, called a *trustee's sale*. [CC §2924]

The lender, carryback seller, homeowners association or other holder of a lien on the real estate with a power-of-sale provision or statutory authority typically forecloses by a trustee's sale. However, if the

Figure 1

*Excerpted from **first tuesday** Form 450—*
Long Form Trust Deed and Assignment of Rents

GRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE

3.6. TRUSTEE'S SALE — On default of any obligation secured by this Deed of Trust and acceleration of all sums due, Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with California Civil Code Sec. 2924 et seq.

secured note evidences a recourse debt with a remaining balance exceeding the *fair price* of the lender's position as the holder of a security interest in the real estate described in the trust deed, the lender may choose a judicial foreclosure and seek a money judgment for any deficiency in the property's value to satisfy the debt. [See Chapter 46]

By foreclosing under the power-of-sale provision, the holder of a lien on real estate avoids a costly court action for judicial foreclosure should the owner default on the trust deed.

Editor's note — When a lender completes a foreclosure by trustee's sale, it cannot then obtain a deficiency judgment against the owner of the secured real estate. On the other hand, the owner cannot redeem the property after the lender's trustee's sale as he can after a judicial foreclosure sale. [See Chapter 43]

Who conducts the sale

A trust deed is a **security device** which by agreement imposes a lien on real estate. It creates a **fictional trust** to "hold title" to the secured real estate for the benefit of the lienholder. Thus, a trust deed has three parties:

- at least one *trustor* (the owner(s) of the secured real estate);
- a *trustee* who need not be named; and
- at least one *beneficiary* (a lender, carryback seller, common interest association or other lienholder).

The trustee's sale is conducted by the **trustee** who is either:

- named in the trust deed; or
- appointed by the beneficiary of the trust deed at the time the beneficiary initiates the foreclosure process.

A broker, attorney, trust deed service, subsidiary of the lender, or the lender itself may be appointed as the trustee. The trustee named in the trust deed, unless replaced by recording a substitution naming another trustee, may process the foreclosure. The trustee begins foreclosure by recording a notice of default (NOD) and ends the process on delivery of the trustee's deed and disbursement of any sales proceeds. [**Bank of America National Trust & Savings Association** v. **Century Land & Water Co.** (1937) 19 CA2d 194; see Figure 2]

Generally, trust deeds prepared and distributed by title or escrow companies name their company as the trustee. However, a trust deed or other security device **need not name** the trustee at all. The beneficiary then simply appoints a trustee to handle the NOD or reconveyance. [See Form 450 in Chapter 14]

Also, the beneficiary may appoint a substitute trustee to replace a named trustee for various reasons, such as:

- the named trustee no longer exists;
- the named trustee is uncooperative; or

Figure 2

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF DEFAULT
with SUBSTITUTION OF TRUSTEE
(California Civil Code §2924c)

IMPORTANT NOTICE

IF YOUR PROPERTY IS IN FORECLOSURE BECAUSE YOU ARE BEHIND IN YOUR PAYMENTS, IT MAY BE SOLD WITHOUT ANY COURT ACTION, and you may have the legal right to bring your account in good standing by paying all of your past due payments plus permitted costs and expenses within the time permitted by law for reinstatement of your account, which is normally five business days prior to the date set for the sale of your property. No sale date may be set until three months from the date this notice of default may be recorded (which date of recordation appears on this notice).

This amount is $__________ as of __________, 20_____, and will increase until your account becomes current.

While your property is in foreclosure, you still must pay other obligations (such as insurance and taxes) required by your note and deed of trust or mortgage. If you fail to make future payments on the loan, pay taxes on the property, provide insurance on the property, or pay other obligations as required in the note and deed of trust or mortgage, the beneficiary or mortgagee may insist that you do so in order to reinstate your account in good standing. In addition, the beneficiary or mortgagee may require as a condition to reinstatement that you provide reliable written evidence that you paid all senior liens, property taxes, and hazard insurance premiums.

Upon your written request, the beneficiary or mortgagee will give you a written itemization of the entire amount you must pay. You may not have to pay the entire unpaid portion of your account, even though full payment was demanded, but you must pay all amounts in default at the time payment is made. However, you and your beneficiary or mortgagee may mutually agree in writing prior to the time the notice of sale is posted (which may not be earlier than the end of the three-month period stated above) to, among other things, (1) provide additional time in which to cure the default by transfer of the property or otherwise; or (2) establish a schedule of payments in order to cure your default; or both (1) and (2).

Following the expiration of the time period referred to in the first paragraph of this notice, unless the obligation being foreclosed upon or a separate written agreement between you and your creditor permits a longer period, you have only the legal right to stop the sale of your property by paying the entire amount demanded by your creditor.

———— PAGE ONE OF THREE — FORM 471 ————

———— PAGE TWO OF THREE — FORM 471 ————

To find out the amount you must pay, or to arrange for payment to stop the foreclosure, or if your property is in foreclosure for any other reason, contact:

____
(Name of Beneficiary or Mortgagee)

____
(Mailing address)

____
(Telephone)

Beneficiary has contacted and discussed avenues for refinance, etc., as required by California Civil Code §2923.5.

If you have any questions, you should contact a lawyer or the governmental agency which may have insured your loan.

Notwithstanding the fact that your property is in foreclosure, you may offer your property for sale, provided the sale is concluded prior to the conclusion of the foreclosure.

Remember, YOU MAY LOSE LEGAL RIGHTS IF YOU DO NOT TAKE PROMPT ACTION.

NOTICE IS HEREBY GIVEN:

A Deed of Trust dated ______________________ executed by ______________________, as the Trustor, in favor of ______________________, as the Beneficiary, recorded on ______________ , as Instrument No. __________, of Official Records in the office of the County Recorder of __________County, California, secures, among other obligations, _______ note(s) in the original amount of $______________.

The beneficial interest under the Deed of Trust is held by the undersigned Beneficiary who HEREBY appoints ______________________ as Trustee under the Deed of Trust.

A default in the obligations secured by the Deed of Trust has occurred in that payment has not been made of:

____

____

____

____

____

____

______________________.

———— PAGE TWO OF THREE — FORM 471 ————

———— PAGE THREE OF THREE — FORM 471 ————

Due to the default, the undersigned Beneficiary has signed and delivered to the Trustee a written Declaration of Default and Demand for Sale, and has deposited with the Trustee the Deed of Trust and all documents evidencing the secured obligations, and hereby declares all sums of the secured obligations immediately due and payable and elects to cause the real estate encumbered by the Deed of Trust to be sold to satisfy the secured obligations.

____
(Signature of Beneficiary)

STATE OF CALIFORNIA
COUNTY OF______________________
On ______________________ before me,
____
(Name and title of officer)
personally appeared ______________________
______________________.

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ______________________
(Signature of notary public)

(This area for official notarial seal)

FORM 471 01-09

- the beneficiary simply wants to use a different trustee for any reason. [CC §2934a]

The stages of foreclosure

A trustee's actions under a **power-of-sale provision** are strictly controlled by California statutes. To successfully complete a trustee's foreclosure sale of the secured real estate, the trustee and beneficiary of the trust deed must adhere to the procedures fully detailed in the foreclosure statutes for handling a trustee's sale. [**Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268]

For the trustee the foreclosure process and fees are broken down into three stages:

1. Recording and serving a notice of default (NOD);

2. Recording, posting and serving the notice of trustee's sale (NOTS); and

3. Conducting the sale of the real estate, which includes auctioning off the property, executing the trustee's deed and distributing any sales proceeds.

In contrast to the three stages for the trustee's processing of the foreclosure, the owner of the real estate and the beneficiary are concerned primarily with two different periods of time which control payment of the debt:

- the *reinstatement period*, which runs from the recording of the NOD and ends prior to five business days before the trustee's sale; and

- the *redemption period*, which also runs from the recording of the NOD but ends with the completion of the trustee's sale of the secured property. [See Chapter 45]

Pre-foreclosure workout prior to NOD

Before recording an NOD on a trust deed securing a purchase-assist loan as a lien on residential property intended to be the borrower's principal residence, which was recorded during the period of 2003 through 2007, a lender must conduct or attempt to conduct a pre-foreclosure workout with the owner.

By at least 30 days prior to recording an NOD on one of these owner-occupied SFR loans, the lender must have made an initial contact, or attempt to contact, with the borrower to:

- assess the borrower's financial situation;

- explore options for the borrower to avoid foreclosure;

- advise the borrower of his right to an additional meeting within 14 days to discuss his financial options;

- provide borrowers with the toll-free Department of Housing and Urban Development (HUD) phone number to find a HUD-certified housing counseling agency; and

- in the event personal or phone contact cannot be made, the lender must exercise due diligence through further attempts to contact the borrower, including:

    - sending a letter via first-class mail to the borrower/owner containing HUD's toll-free number used to find and contact a HUD-certified counseling agency;

    - after sending the letter, the lender may employ an automated dialing system to telephone the borrower on at least three different days and at different hours, provided a live representative is available if the borrower answers the call; and

    - make at least three attempts to reach the borrower by phone, unless the lender determines all the borrower's telephone numbers on file have been disconnected.

If the lender is unable to make contact with the borrower by these methods, the lender must send the borrower a certified letter, return receipt requested, containing a toll-free number with access to a representative during business hours.

When contacting an owner whose principal residential loan is in default:

- a lender's loss mitigation personnel may participate in any telephonic communication;

- the borrower may select a HUD-certified agent to represent him during any meeting with a lender to discuss ways of avoiding foreclosure; and

- any loan modification or plan to avoid foreclosure offered by the lender is subject to the borrower's approval.

The lender may record an NOD on a loan without complying with any of these 30-day pre-foreclosure requirements when the borrower has:

- surrendered the property to the lender either by letter confirming the surrender or by delivery of the keys to the lending institution;

- contracted with a person who facilitates a borrower's decision to leave their home by extending the foreclosure process and avoiding the lender's enforcement of the loan; or

- filed a bankruptcy petition which is pending.

The NOD controlled by pre-foreclosure work-out rules must, when recorded, include a declaration stating:

- the lender succeeded in contacting the borrower according to the above guidelines;

- the lender was unable to contact the borrower, despite exhausting all due diligence efforts; or

- the borrower has surrendered the property to the lending institution.

To be **due-diligent** compliant, the lender must, before making the initial contact (or attempt to contact) with the borrower to commence the 30-day pre-foreclosure workout for recording the NOD, post a prominent link on the lender's website containing information, including:

- options available for a borrower who is unable to make his mortgage payment and wants to avoid foreclosure;
- a list of financial documents a borrower needs to have when discussing alternatives to foreclosure with the lender;
- a toll-free telephone number for a borrower to call to discuss alternatives to foreclosure with their lender; and
- the toll-free number made available by HUD for the borrower to find and contact a HUD-certified housing counseling agency. [CC §2923.5]

Trustee's sale guarantee

When a trust deed is in default and the beneficiary has chosen to foreclose on the property, the beneficiary delivers a **Declaration of Default and Demand for Sale** to the trustee. The declaration contains instructions directing the trustee to initiate foreclosure on the secured real estate as authorized under the power of sale granted in the trust deed. [See Figure 2]

Even though the trustee may have received the beneficiary's declaration of default, the trustee's foreclosure process does not begin and foreclosure fees are not incurred by the property owner until the trustee or beneficiary records a notice of default (NOD). [**System Investment Corporation** v. **Union Bank** (1971) 21 CA3d 137]

Once the NOD is recorded, the trustee must strictly follow statutory notice requirements. To be assured he serves all the required notices on the proper persons, the trustee orders out a *trustee's sale guarantee* from a title company before or at the time the NOD is recorded.

The trustee's sale guarantee provides **coverage** for the trustee should he fail to service notices on any party of record due to an omission in the guarantee.

The **trustee's sale guarantee** advises the trustee on:

- who must receive a copy of the NOD and notice of trustee's sale (NOTS) — the person(s) entitled to receive notice that the secured obligation is subject to a recorded notice of default (NOD) and the property will be sold nonjudicially at the trustees's sale; and
- the location of the secured real estate where a copy of the NOTS will be posted and in which newspapers the NOTS will be published.

Thus, the trustee's sale guarantee contains:

- the name and address of each person who has recorded a request for a copy of the NOD;
- the name and address of each party with a recorded interest in the real estate securing the obligation in default;

No address for the owner

The trustee must send a copy of the notice of default (NOD) to:

- the owner's address as noted in the trust deed; and
- the address given by the owner in a recorded request for NOD. [CC §2924b(b)(3)]

If the trust deed does not contain a request for NOD, or contains a request for NOD but no address for the owner, the trustee can do one of the following starting within 10 business days after recording the NOD:

- publish the NOD once a week for at least four weeks in a newspaper of general circulation in the county in which the property is located (the trustees sale guarantee issued by the title company advises which newspaper to use);
- personally serve the NOD on the owner; or
- post the NOD in a conspicuous place on the secured property and mail the notice to the last known address of the owner. [CC §2924b(d)]

A trustee is not required to discover an owner's address if the current address is not actually known to the trustee. [**I.E. Associates** v. **Safeco Title Insurance Company** (1985) 39 C3d 281]

Unless the trustee has actual knowledge of the owner's last known physical address, which does not include the use of an email or electronic address, the trustee is not liable if the owner does not receive a copy of the NOD. [CC §2924b(b)(3)]

- any junior (later recorded) easements and to whom the easements were granted;
- the property's legal description;
- a plat map locating the property; and
- the names of the newspapers in general circulation in which the NOTS, and the NOD if necessary, are to be published.

Additionally, the trustee employs the title company as his agent to record documents, such as the NOD, NOTS, rescission of NOD and the trustee's deed.

The notice of default and election to sell

When ordering out a trustee's sale guarantee from a title insurance company, the trustee instructs the title company to **record the notice of default** (NOD) in the office of the county recorder in the county or counties where the secured real estate is located. [CC §2924]

The NOD contains a statutorily mandated statement which sets forth the *monetary default* on the note or other obligation secured by the trust deed. [CC §2924c(b)(1)]

The **monetary default** statement informs the owner:

- he must continue to pay other obligations required of him by the trust deed, such as hazard insurance and property taxes; and

- if he does not make future payments on the obligations in default, the owner is required to make the payments to reinstate the loan. [See Figure 2]

The NOD does not need to state the actual amounts of the monetary defaults on the recurring obligations. However, the NOD must state the nature of the present defaults on the note and the trust deed, such as failure to have paid hazard insurance premiums and property taxes. [CC §2924c(a)(1)(B)]

To determine the amount needed to cure the default, the NOD usually directs the owner or other interested persons seeking to reinstate the trust deed or redeem the property to contact the trustee by listing the trustee's name, address and telephone number after the beneficiary's name on the NOD.

Thus, the trustee insulates the beneficiary from all direct contact with the owner or junior lienholder during the foreclosure process.

If the NOD does not list a default actually known to the beneficiary at the time of recording, the unnamed default does not need to be cured for the loan to be reinstated. [**In re Peters** (9th Cir. BAP 1995) 184 BR 799]

However, the beneficiary may later record a separate NOD to notice the omitted default, and pursue a separate foreclosure based on the omitted default. [CC §2924]

Delivering the NOD

Within 10 business days after recording a notice of default (NOD), **two copies** of the NOD are mailed to each:

- the owner of the property;

- the administrator of a deceased owner's estate; and

- each person who has recorded a request to receive a copy of the NOD. [**Estate of Yates** v. **West End Financial Corporation, Inc.** (1994) 25 CA4th 511; CC §2924b(b)(1)]

One copy of the NOD is sent by registered or certified mail, the other copy is sent by first-class mail. [CC §2924b(b)(1), (e)]

Within one month after recording the NOD, the trustee is required to send a copy of the NOD by registered or certified mail and another copy by first-class mail to holders of a **recorded interest** in the secured property, including:

- the owner's successor-in-interest to the estate or any portion thereof (easements);

- any junior trust deed holder;

- the assignee of a junior trust deed;

Figure 3

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF TRUSTEE'S SALE

IMPORTANT NOTICE

YOU ARE IN DEFAULT UNDER A ___________________________, DATED _____________. UNLESS YOU TAKE ACTION TO PROTECT YOUR PROPERTY, IT MAY BE SOLD AT A PUBLIC SALE. IF YOU NEED AN EXPLANATION OF THE NATURE OF THE PROCEEDING AGAINST YOU, YOU SHOULD CONTACT A LAWYER.

On _____________, 20______, at ____, California, ____, as Trustee or Successor Trustee under a Trust Deed dated __________________, executed by ____, as the Trustor, for the benefit and security of ____, as the Beneficiary, recorded _____________________, as Instrument No. __________________ in the records of the County Recorder, County of ____, State of California.

YOUR PROPERTY MAY BE SOLD AT PUBLIC AUCTION TO THE HIGHEST BIDDER FOR CASH, A CASHIER'S CHECK DRAWN ON A STATE OR NATIONAL BANK, A STATE OR FEDERAL CREDIT UNION, OR A STATE OR FEDERAL SAVINGS AND LOAN ASSOCIATION/THRIFT DOMICILED IN THE STATE OF CALIFORNIA (payable at time of sale in lawful money of the United States) at ____ ____, all rights, title and interest conveyed to and now held by it under said Trust Deed in the property situated in said County and State referred to as:

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— — — — — PAGE TWO OF TWO — FORM 474 — — — — —

The street address and other common designation, if any, of the real property described above is purported to be ____ ____.

County assessor's parcel number _______________________________.

THE TRUSTEE DISCLAIMS ANY LIABILITY FOR INCORRECT INFORMATION FURNISHED.
The auction sale is made without covenant or warranty regarding title, possession or encumbrances, or as to insurability of title.

The total amount of the unpaid balance of said obligations together with advances, and estimated costs and expenses, is $________________.

The notice of breach of this obligation and election to sell said real property was recorded as Instrument No. ____________________________, on _____________, 20______, of Official Records in the office of the County Recorder of ____ County, State of California.

Date: ______________, 20______

Address: ____ Trustee: ____

____ By: ____

Phone: ____ Title: ____

Fax: ____

Email: ____

STATE OF CALIFORNIA
COUNTY OF_________________________________
On ____ before me,
____
(Name and title of officer)
personally appeared ________________________________
____,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.
I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.
WITNESS my hand and official seal.
Signature ____
(Signature of notary public)

(This area for official notarial seal)

FORM 474 04-08

Trustee's duties

A trustee under a trust deed has no fiduciary duty to either the noteholder or the property owner since the "trust" purportedly created by a trust deed is not an actual trust. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc**. (1989) 49 C3d 454]

A trustee under a trust deed has two duties owed to all involved, both of which are regulated by statute:

- *reconvey* the trust deed on satisfaction of the secured debt [CC §2941];
- exercise the *power of sale* on a default in the trust deed. [CC §2924 et seq.; Monterey, *supra*]

- a buyer on a land sales contract;
- a lessee on a lease; and
- the state Office of the Controller, if a **Notice of Lien for Postponed Property Taxes** is recorded against the property. [CC §2924b(c)]

Any person interested in obtaining a copy of the NOD, and who is not listed in the statute as a person who is to automatically receive notice, must record a **request for NOD** to assure they will be notified of the default and sale, such as a request by a tenant under an unrecorded lease or a licensee with signs located on the property. [See Form 412 in Chapter 28]

Proof of service required for mailing

A trustee or person depositing the notice of default (NOD) into the mail must prepare a proof of service form and include a copy of the form with the NOD in each mailing. [CC §2924b(e)]

The completed copy of the proof of service form (held in the trustee's file) conclusively establishes the NOD was mailed to the persons listed in the form, i.e. the parties entitled to receive the NOD. [CC §2924b(e)]

When the statutory rules for mailing, serving, posting or publishing the NOD are met as reflected in the trustee's file, the statutory service requirement is satisfied, even if the current owner of the property or other intended recipients never actually receive the NOD. [CC §2924b(e)]

If the trustee does not meet the statutory service requirements, the trustee's sale may be voidable, depending on whether the foreclosing lender (voidable) or a third party (not voidable) buys the property.

The notice of trustee's sale

A trustee (or beneficiary) may begin noticing the date set for the sale of a property by foreclosure on the day following **three months after** the notice of default (NOD) is recorded. [CC §2924]

The date the sale will be held may be set for any business day, Monday through Friday, between the hours of 9 a.m. and 5 p.m. [CC §2924g(a)]

In general practice, a *date down* of the trustee's sale guarantee issued to the trustee is ordered out from the title company the day before or the day on which the title company, as instructed, records the notice of trustee's sale (NOTS).

The **date down** notifies the trustee of any interests recorded on the title to the property after the NOD is recorded. However, the trustee is not required to give notice of the impending trustee's sale to any person who recorded an interest in the property after the NOD was recorded. [CC §2924b(c)(1)]

The trustee prepares an NOTS which contains:

- the trustee's or his agent's name, street address and telephone number (or toll-fee number if located out of state);
- the street address or common designation of the secured property;
- the county assessor's parcel number of the secured property;
- the dollar amount of the debt in default, including reasonably estimated advances for hazard insurance premiums, property taxes due and foreclosure costs; and
- a statutory statement informing the owner he is in default. [CC §2924f; see Figure 3]

If the property does not have a street address or other common designation, the NOTS must contain:

- a legal description of the property;
- a statement that directions to the property can be obtained from the beneficiary by written request within 10 days from the first publication of the NOTS; and
- the name and address of the beneficiary requesting the sale of the property. [CC §2924f(b)]

If the billing address of the defaulting borrower/owner is different from the secured property's address, then, concurrent with the posting of the notice of trustee's sale (NOTS) on the property, an additional notice must be posted by the new property owner, stating in English and five other mandated languages that any tenant has the right to a 60-day notice to vacate the property.

A copy of this tenant's rights notice must also be mailed at the time of posting as a letter addressed to the "Resident of property subject to foreclosure sale." [CC §2924.8; see **first tuesday** Form 474-1]

The NOD and NOTS in Spanish

If the loan secured by the trust deed was negotiated in Spanish, the trust deed may contain a request for a Spanish-language notice of default (NOD). The trustee is then obligated to serve the owner an NOD translated into Spanish. [CC §2924c(b)(1)]

The trustee does not need to serve the owner of the property with a Spanish-language NOD if:

- the trust deed does not contain a request for a Spanish-language NOD; or

- the trustee does not have actual knowledge the loan was negotiated in Spanish. [CC §2924c(b)(1)]

When a Spanish-language NOD is required to be served and the beneficiary fails to instruct the trustee to serve one when the trust deed failed to request a Spanish-language NOD, the beneficiary will be liable for any money losses incurred by the owner of the secured property for failure to serve a Spanish-language NOD.

When a trust deed is negotiated in Spanish, a notice of trustee's sale (NOTS) served on the owner must be accompanied by a Spanish translation since the NOTS alters the owner's rights and obligations. [CC §1632(d)]

Delivering the NOTS

At least **20 calendar days before** the date selected by a trustee to hold a trustee's sale, the trustee must send two copies of the notice of trustee's sale (NOTS) to each party the trustee previously sent the notice of default (NOD). [CC §2924b(c)(3)]

As with the NOD, one copy of the NOTS is sent by registered or certified mail, while the other is sent by first-class mail. [CC §2924b(b)(2), (e)]

To ensure the sale of the secured property at a public auction is properly advertised, the notice requirements for the NOTS are more comprehensive than the notice requirements for the NOD.

In addition to mailing the notice to all interested parties of record, the trustee must perform all of the following at least **20 calendar days** prior to the sale:

- **post a copy** of the NOTS in one public place in the city of the sale, or if the sale is not to be held in a city, the judicial district in which the property is to be sold;

- **post a copy** of the NOTS in a conspicuous place on the property to be sold (for example, a door if the property is a single family residence); and

- **start publishing a copy** of the NOTS once a week for three consecutive calendar weeks in a newspaper of general circulation in the city where the property is located (the name of the newspaper is provided by the title company in the trustee's sale guarantee.) [CC §2924f(b)(1)]

Editor's note — A "calendar week" means Monday through Saturday. [CC §2924f(a)]

For example, if a sale is set for a Wednesday, advertising the sale for the three consecutive Thursdays occurring prior to the sale date satisfies the publishing requirement.

If the property is not located in a city, or a newspaper is not published in the city, the trustee may publish the notice in an adjudicated newspaper of general circulation in the judicial district where the property is located. [CC §2924f(b)(1)]

The trustee then instructs the title company to record the NOTS in the county where the property is located on a date at least **14 calendar days before** the sale date. [CC §2924f(b)(1)]

For example, the NOTS would have to be recorded **no later than** Wednesday the 14th if the sale date selected was Wednesday the 28th.

No statutory duty to notify the IRS

An Internal Revenue Service (IRS) tax lien recorded within 30 days of the actual trustee's sale is eliminated by the trustee's sale, and the IRS then has no right to its **120 day redemption** of the property after the foreclosure sale.

When a **date down** is ordered on the foreclosure guarantee policy prior to the 20-day advertising period before sale, the trustee may discover an IRS tax lien has been recorded since recording the notice of default (NOD).

To eliminate an IRS tax lien which was recorded more than 30 days before the sale date, but after the NOD was recorded, the IRS must be served notice of the sale postmarked at least **25 days before** the sale date. [Internal Revenue Code §7425]

However, the trustee has no statutory duty to serve the IRS with a notice of trustee's sale (NOTS). [**Diediker** v. **Peelle Financial Corporation** (1997) 60 CA4th 288; CC §2924b(c)(2)]

Additionally, federal statutes do not require the IRS to be notified of any private sale of secured real estate. [IRC §7425(b)]

Thus, a beneficiary **must instruct** the trustee to set the sale date and give the notice needed to eliminate any IRS tax lien recorded after recording the NOD.

The location of the sale

A trustee's sale must be held in the county where the secured real estate is located. [CC §2924g(a)]

If the property or properties being foreclosed are located in two or more counties, the trustee's sale may take place in any one of the counties where the property, or a portion of the property, is located. [CC §2924g(b)]

For example, consider a trustee who is to conduct a foreclosure sale of two properties which secure the same debt by the same trust deed and are located in different counties.

The trustee can sell both properties at one sale, in either county the trustee chooses. Also, the trustee can hold the sale in any area of the chosen county.

Foreclosing a blanket trust deed

If more than one property is security under one trust deed, and the properties are to be sold at the same trustee's sale, the trustee may auction off the properties one at a time. The first property will be sold at the time published in the notice of trustee's sale (NOTS). Each additional property will be sold immediately following completion of the preceding sale(s). [CC §2924g(a)]

If the owner of the property is present at the sale, he may direct the order in which the trustee sells the secured properties, should a certain order of the sales be advantageous to the owner. [CC §2924g(b)]

Unless the trust deed holder or lienholder foreclosing faces an additional risk of loss, the first properties sold should be those which have not been further encumbered with liens junior to the trust deed being foreclosed. The second and any further properties sold should be encumbered with one junior lien, then two liens junior, etc., a procedure called the *inverse order of alienation*. [CC §2899]

When two or more properties are being foreclosed under the same trust deed, the price paid by the highest bidder for the first property frequently does not fully satisfy the sums due under the trust deed. Here, the trustee will immediately begin the sale of the second property. The trustee then continues to sell the properties until enough have been sold to fully satisfy the debt. [CC §2924g(b)]

However, a trustee may sell the secured properties as a whole for one price, if he is authorized to do so under the trust deed. [**In re Affordable Housing Development Corporation** (9th Cir. BAP 1994) 175 BR 324; CC §2924g(b)]

Institutionally created trust deeds typically include language in the **power-of-sale provision** allowing the trustee to sell the secured properties as a whole or individually in any order determined by the trustee, at the discretion of the beneficiary.

*Editor's note — **first tuesday** Form 450 Long Form Deed of Trust and Assignment of Rents, does not contract away a property owner's right to direct the order in which his properties are sold or the rule of inverse order of alienation.*

Postponing the sale

A trustee's sale may be postponed by the trustee at any time prior to the completion of the foreclosure sale. The trustee's sale may be postponed on the instruction of the beneficiary or by the trustee at his own discretion. [CC §2924g(c)(1)]

Consider a trustee conducting a sale of four parcels of real estate who opens bidding on the first parcel to be sold.

An agent of the beneficiary makes a full credit bid on the first parcel being sold. Before the trustee accepts the bid, the owner, who is present at the sale, disrupts the proceedings and declares the sale is over since the beneficiary made a full credit bid on the first parcel.

In response, the trustee announces the sale is to be postponed to a new date.

In this example, the trustee's postponement of the sale is proper since the high bid has not yet been accepted by the trustee. The trustee has **discretionary authority** to postpone the trustee's sale to protect either the owners or the beneficiary's interest in the properties being foreclosed. [**Hatch** v. **Collins** (1990) 225 CA3d 1104]

Also, the postponement of a trustee's sale which has been initiated but not completed cancels the last bid. [CC §2924h(e)]

Thus, the beneficiary's full credit bid on the first parcel of real estate was canceled since the bid had not been accepted by the trustee. The beneficiary's agent bidding at the next trustee's sale will probably underbid on each parcel until he has used up his entire credit bid or acquired all the properties.

To postpone or reschedule a trustee's sale, the trustee gives **notice of postponement** at the time and place stated in the notice of trustee's sale (NOTS) for the sale by a public declaration of:

- the reason for the postponement; and
- the new date and time of the foreclosure sale.

Figure 4

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

MAIL TAX STATEMENTS TO

Name

Street Address

City & State

DOCUMENTRY TRANSFER TAX $______________

☐ Grantee was the foreclosing vendor; consideration $______________; unpaid debt $______________; nonexempt amount $______________;

☐ Computed on the consideration or value of the property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

____
(Signature of Declarant or Agent)

APN# ______________________________________

TRUSTEE'S DEED UPON SALE

____, as the Trustee,
does hereby grant and convey, but without covenant or warranty, express or implied, to ______________________
____, herein called Grantee,
the real property in the City of ____,
County of ____, State of California, referred to as:

— — — — PAGE ONE OF TWO — FORM 475 — — — —

— — — — PAGE TWO OF TWO — FORM 475 — — — —

This conveyance is made pursuant to the authority and powers vested in said Trustee, as Trustee, or Successor Trustee, or Substituted Trustee, under that certain Deed of Trust executed by ______________________________________
____, as the Trustor,
recorded ________________________ as Instrument No. ____________________, of Official Records in the Office of the Recorder of ____ County, California; and pursuant to the Notice of Trustee's Sale recorded ____________, 20______, as Instrument No. ______________________, of Official Records of said County, Trustee having complied with all applicable statutory requirements of the State of California and performed all duties required by said Deed of Trust including, among other things, as applicable, the mailing of copies of the Notices of Sale or the publication of a copy of the Notice of Default or the personal delivery of the copy of the Notice of Default or the posting of copies of the Notice of Sale or the publication of a copy thereof. At the time and place fixed in the Notice of Trustee's Sale, said Trustee did sell said property above described at public auction to said Grantee, being the highest bidder therefor, for $______________ cash, lawful money of the United States.

Dated: ____________, 20______

Trustee: ____________________________________

By: ____

Title: ______________________________________

STATE OF CALIFORNIA
COUNTY OF____
On ____ before me,
____
(Name and title of officer)
personally appeared ________________________________
____.

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ____
(Signature of notary public)

(This area for official notarial seal)

TAX STATEMENTS TO BE MAILED AS DIRECTED ABOVE

FORM 475 04-08

The postponed trustee's sale must also be held at the **same place** originally stated in the recorded NOTS. [CC §2924g(d)]

Editors note — Prior to the legislation which required a postponed trustee's sale to be held at the location specified in the recorded NOTS, some lenders and their trustees played chill-bidding games by scheduling sales in locations which were out-of-the-way to ensure the lender was the high bidder on a credit bid. Postponed trustee's sales would be rescheduled at distant, purposefully difficult to find locations to discourage other persons from attending and bidding at the sale.

The trustee may postpone the sale multiple times, postponing it to occur at any time prior to 365 days from the sale date set in the original recorded NOTS. Should the sale be postponed to a date later than the 365 days following the date set in the NOTS, the trustee must renotice the sale by recording, publishing, posting and serving a new NOTS. [CC §2924g(c)(1), (2)]

Postponements of the sale must be made in accordance with any of the following:

- a mutual agreement, written or oral, between the trustor (owner) and the beneficiary;
- a court order;
- a stay caused by operation of law, such as occurs on the filing of a bankruptcy petition; or
- at the discretion of the trustee. [CC §2924g(c)(2)]

Additionally, the sale may be held no sooner than the seventh day after the earlier of:

- the dismissal of an action; or
- the termination or expiration of an injunction, restraining order, or stay. [CC §2924g(d)]

The sale may be held prior to the expiration of the seven day period only if directed by the court. If the sale is scheduled to occur during the seven day period without a court order, the sale must be postponed and a new notice of postponement must be given. [CC §2924g(d)]

The trustee is required to keep records of all postponements and the reason for each postponement. [CC §2924g(d)]

Sold to the highest bidder

A trustee's sale is essentially a **public auction** by private agreement (the trust deed) where the property is sold to the highest bidder. [CC §2924h]

Before the actual trustee's sale begins, the trustee can:

- demand all prospective bidders to show evidence of their financial ability to pay as a precondition to recognizing their bids; and
- hold the prospective bidders' amounts to be bid. [CC §2924h(b)(1)]

NOTICE OF SURPLUS FUNDS FROM TRUSTEE'S SALE

DATE: ____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

Regarding ____

Trustee's foreclosure sale number ____

To ____

____

____

1. On ____________, 20______, a trustee's sale took place of the real estate referred to as ________________

____

____.

2. Excess funds remain from the proceeds of the trustee's sale.

3. You may have a claim to all or a portion of the excess sales proceeds. If so, submit your claim to
Trustee's name ____________________________________
Address ____

____

4. Before Trustee can act on your claim, any claim you submit must be in writing and signed by you under penalty of perjury and include:

4.1. The total amount of your claim to the date of the trustee's sale.

4.2. An itemized statement of the principal, interest of other charges authorized by law for payment.

5. Your claim must be received by Trustee at the address noted in Section 3 above no later than **30 days** from the date of this notice.

This notice has been prepared and posted by

____
(Foreclosure Officer)

A bidder can tender his bid amount in U.S. dollars in the form of:

- cash;
- a cashiers check drawn on a state or national bank;
- a check issued by a state or federal thrift, savings and loan association (S&L), savings bank or credit union; or
- a cash equivalent designated by the trustee in the notice of trustee's sale (NOTS), such as a money order. [CC §2924h(b)(1)]

Each bid made at a trustee's sale is an **irrevocable offer** to purchase the property. However, any subsequent higher bid cancels a prior bid. [CC §2924h(a)]

The trustee's sale is considered final and completed on the trustee's **acceptance** of the last and highest bid. [CC §2924h(c)]

Once the highest bid has been accepted by the trustee, the trustee can require the highest bidder to immediately deposit the full amount of the final bid with the trustee, if the trustee is not already holding all the bidders' funds. [CC §2924h(b)(2)]

If the highest bidder tenders payment by a check issued by a credit union or a thrift, the trustee can refrain from issuing the trustee's deed until the funds become available. [CC §2924h(c)]

Failure to deliver payment of a bid

If a high bidder tenders payment by check and the funds are not available for withdrawal:

- the trustee's sale is automatically **rescinded**; and
- the trustee will send the highest bidder a *notice of rescission* for failure of consideration, provided the trustee has the bidder's address. [CC §2924h(c)]

To hold a new trustee's sale auction, the trustee must set a new trustee's sale date and record, serve and publish a new notice of trustee's sale (NOTS), following all statutory requirements.

The highest bidder who fails to tender payment when demanded or cancels the check is liable to the trustee for all damages resulting from the **refusal to tender** payment, including court costs, reasonable attorney fees and the costs for recording and serving the new NOTS. [CC §2924h(d)]

In addition, the bidder who fails to tender payment or cancel the check will be guilty of a misdemeanor punishable by a fine up to $2,500. [CC §2924h(d)]

Consider a buyer who was the highest bidder on real estate at a trustee's foreclosure sale. The buyer paid the bid with cashier's checks.

Before the bank issuing the checks delivered the funds to the trustee, the buyer stopped payment by handing the bank his declaration that the cashier's checks had been lost without being endorsed. The beneficiary made a demand on the buyer for the amount of the bid at the trustee's sale.

The buyer claimed the beneficiary was barred from enforcing the bid since his only remedy for failure of payment was to re-notice the trustee's sale and recover the costs of re-noticing and holding another trustee's sale.

The beneficiary claimed the buyer was liable for the price bid since the declaration to the bank which stopped payment of the cashier's checks tendered in payment of the price bid was wrongful conduct.

Is the buyer liable for the amount of his bid at the trustee's sale?

Yes! Liability is imposed on the buyer for the full amount of his bid at the trustee's sale since his wrongful conduct induced the bank not to pay on the cashier's checks, which interfered with the trustee's receipt of funds for disbursement to the beneficiary. [**California Golf LLC** v. **Cooper** (2008) 163 CA4th 1053]

Bids by the beneficiary

The beneficiary is frequently the only bidder, and thus the highest bidder, at a trustee's sale. The beneficiary may bid, without tendering funds, up to an amount equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses, called a *full credit bid*. [CC §2924h(b)]

If the beneficiary is the highest bidder under a **full credit bid**, the trustee retains possession of the beneficiary's note (or other evidence of the secured debt) in exchange for the trustee's deed to the property.

However, the beneficiary is not required to bid the full amount of the indebtedness to acquire the property at the trustee's sale. The beneficiary can bid an amount below the full amount of the debt, called an *underbid*.

For example, a beneficiary commences foreclose on three properties encumbered by a trust deed in default. The balance due on the trust deed note is $90,000. The beneficiary, being the sole bidder at the trustee's sale, bids in each property for $30,000.

As a result, the lender acquires each parcel of secured real estate sold at the trustee's sale.

By **underbidding** on two or more properties being sold, the beneficiary can continue to "bid in" the secured properties, a process called *piecemeal foreclosure*, until:

- the high bids have satisfied the debt; or
- all secured properties have been sold.

Conveyance by a trustee's deed

On the completion of a trustee's sale, the trustee uses a *trustee's deed* to grant title to the property to the highest bidder. [See Figure 4]

When a buyer other than the beneficiary purchases the property at a trustee's sale for value and without notice of any title or trustee's sale defects, the buyer is considered a *bona fide purchaser* (BFP).

The **BFPs** interest in the property sold is *perfected* as of 8 a.m. on the date of the trustee's sale, if the trustee's deed conveying the property to the BFP is recorded:

- within **15 calendar days** after the date of the trustee's sale; or
- the **next business day** following the fifteenth day after the sale if the county recorder in the county where the property is located is closed on the fifteenth day. [CC §2924h(c)]

The title received by the third party BFP bidder at the trustee's sale is clear of any interest claimed by the owner, lienholders or tenants whose interests are junior to the foreclosed trust deed. [**Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605]

More importantly, the title is taken clear of any **unrecorded prior interests** or **claims** in the property held by persons **not in possession** of the real estate. However, the highest bidder must be a BFP with no *constructive notice* or actual knowledge of those priority claims when acquiring title to the property at the trustee's sale. [CC §§1107, 1214]

Additionally, a *lis pendens* recorded against the real estate prior to the trustee's sale places bidders on constructive notice of a lawsuit involving a claim to a right in title or to possession of the real estate. The claim may have **priority** to the trust deed being foreclosed. If so, the **lis pendens** destroys the BFP status of the highest bidder as to the person asserting the claim, called a *claimant*.

The buyer of real estate, whether or not purchased at a trustee's sale, takes title to the property subject to the **claimant's** rights disclosed by the lis pendens if the claims have priority to the trust deed being foreclosed.

Additionally, unlike other tax liens, property tax liens and improvement district bond liens are not extinguished by the trustee's sale since they have priority over the trust deed being foreclosed. [**Sohn** v. **California Pacific Title Ins. Co.** (1954) 124 CA2d 757]

Surplus funds

The price paid for property by the highest bidder at a trustee's sale occasionally exceeds the amount of debt and costs due under the foreclosed trust deed. The excess amounts are called *surplus funds*. The trustee has a duty to distribute the **surplus funds** to the junior lienholders and the owner(s). The gross proceeds from the trustee's sale are distributed in the following order:

- to pay the costs and expenses of the trustee's sale, including trustee's fees or attorney fees;
- to pay the indebtedness secured by the property which is in default, including advances made by the beneficiary;
- to satisfy the outstanding balance of junior lienholders of the property, distributed in the order of their priority; and
- to the owner, the owners successor-in-interest or the vested owner of record at the time of the trustee's sale. [CC §2924k(a)]

When surplus funds remain after payment of foreclosure costs and satisfaction of the secured debt, the trustee must either:

- send a *notice of surplus funds* by registered or certified first-class mail to all parties who were entitled to receive a notice of default (NOD); or
- file an **interpleader action** and deposit the funds with the court within 30 days after the execution of the trustee's deed. [CC §2924j(a); see Form 479 accompanying this chapter]

The **notice of surplus funds** will state:

- the property has been sold at a trustee's sale;
- the party receiving the notice may have a claim to the sale proceeds;
- any claim made must be in writing, signed under penalty of perjury and submitted to the trustee within 30 days of the date of the notice; and

- the claim must include the amount of the claim and an itemized statement of principal, interest and other charges. [CC §2924j(a)]

If, after exercising due diligence to determine the priority of written claims, the trustee is unable or uncertain how to distribute the sale proceeds, the trustee:

- files a declaration of the unresolved claims with the applicable court in the county where the sale occurred; and

- deposits the proceeds with the clerk of the court. [CC §2924j(c)]

Trustee's fees

Any fee paid by a trustee to an agent employed by the trustee to perform services may not, when combined with other trustee's fees, exceed the total amount the trustee is authorized to receive as payment. [CC §2924d(d); see Chapter 51]

Costs and expenses recoverable by the trustee, in addition to the trustee's fee, are limited to the costs incurred for recording, mailing, publishing and posting notices. The trustee may also charge up to $50 per postponement of the sale, and an insurance premium, the amount of which is not limited, for obtaining a trustee's sale guarantee. [CC §2924c(c)]

Any **kickbacks**, rebates or referral fees to others involving the services provided by the trustee are prohibited. A trustee or other person who violates this rule is liable to the property owner for **three times** the amount of the kickback, rebate or referral fee. [CC §2924h(g)]

The **trustee named** in the trust deed often refers foreclosure requests to other persons who act as professional foreclosure trustees. For this referral, the named trustee cannot legally collect a referral fee. The same prohibition would apply to beneficiaries who appoint a trustee based on a kickback to the beneficiary of a portion of the trustee's fee should a third-party bidder acquire the property at the trustee's sale.

Additionally, the trustee may charge a fee for any costs and expenses incurred in distributing the sale proceeds, including investigating the priority and validity of junior claims. The trustee may charge a fee of no more than $125 for performing the distribution services. [CC §2924k(b)]

Chapter 48 — Requests for default and delinquency notices

This chapter discusses a private lender's and a carryback seller's use of recorded requests for notice to protect his security interest in real estate in the event of a delinquency or commencement of foreclosure under a senior trust deed.

Protection of the last resort

A seller who carries back a note and trust deed secured by the property sold or a private money trust deed lender generally holds a trust deed lien which is junior to a pre-existing trust deed lien held by a lender, called a *senior trust deed*.

The carryback seller holding a **second trust deed**, like a private equity lender or long-term tenant, needs to protect himself against the foreseeable risk of the loss of his interest in the property due to a delinquency and foreclosure by the senior trust deed holder. A foreclosure sale of the property by the senior trust deed holder would eliminate the carryback seller's or equity lender's trust deed lien on the property, called *exhaustion of the security*.

Two procedures exist for the carryback seller or private lender whose note is secured by a junior trust deed, or a tenant, to receive notice from the senior trust deed holder regarding **defaults** and **foreclosure** proceedings on the senior trust deed:

- **Request for Notice of Default** (NOD) — notice will be sent to the person recording a request for notice within 10 business days after a senior lienholder initiates foreclosure by recording an NOD; and

- **Request for Notice of Delinquency** (NODq) — notice will be sent to the person requesting the notice within 15 calendar days after four consecutive months of unpaid and delinquent monthly installments on the senior trust deed note.

Anyone, whether or not they hold an interest in the property, such as the carryback seller, private lender, tenant of the property, or participant in any entity holding title, may **record a request** to receive a copy of any NOD which is later recorded under the trust deed identified in the request. The request does not require the consent of the property owner (or anyone else) and may be recorded at any time.

Conversely, the carryback seller or private lender must first obtain the consent of the buyer or owner of the property in order to process a Request for NODq. Consent is best obtained by including a provision in the purchase agreement or loan agreement entered into with the buyer or owner, or on a later modification of a note. [See **first tuesday** Forms 150 §8.3 and 426 §7.6]

The buyer or owner consents to the NODq and the release of information by signing the request form. The request form is then recorded and a copy served on the senior lender through escrow. [See Form 412 accompanying this chapter]

The senior trust deed holder will only release delinquency information if the request form is signed by the buyer or owner who originated or assumed the loan.

Use of the request for an NODq is only available to persons with an ownership interest (tenant or co-owner) or security interest in the property. [Calif. Civil Code §2924e(b)]

The NOD Request

Anyone, however, may record a Request for Notice of Default (NOD). A recorded Request for NOD must identify:

- the person requesting a copy of the NOD, called the *requestor*, by name and address; and

- the trust deed on which a copy of the NOD commencing foreclosure is requested.

To be valid, the Request for NOD only needs to be recorded in the county where the property is located. No service of the request on the lender is required.

To initiate foreclosure by a trustee's sale, the trustee, on instructions from the trust deed holder, records the NOD. The NOD states the nature of an owner's money default, and what can be done (if anything) to bring the loan current, called *reinstatement*.

Within 10 business days following the recording of the NOD, the **trustee must mail** two copies of the NOD to each person who recorded a request for notice: one by registered or certified mail, the other by first-class mail. [CC §§2924b(b)(1), (e)]

A carryback seller or private lender who have not recorded a Request for NOD and whose trust deed is junior to a trust deed on which an NOD has been recorded will still be sent two copies of the NOD **within one month** after the NOD is recorded; one by certified or registered mail, the other by first-class mail. [CC §2924b(c)]

By recording the Request for NOD, the junior lienholder is sent notice of the NOD in 10 days, not 30 days, giving a 20 day head start to either **reinstate** (bring current) the delinquent loan or **redeem** (pay off) the property, if the owner does not.

However, the trustee's **sending** a copy of the NOD, which is the minimum attempt required to effect service, and the requestor's **receiving** a copy of the NOD are entirely different events.

Receiving an NOD

Foreclosure trustees mail a copy of the recorded notice of default (NOD) to the last address of record, or the present address of the property owner or junior lienholders if it is actually known to the beneficiary or trustee. [CC §2924b(b)]

For example, a Request for NOD is recorded by a carryback seller to reflect his **change of address** from the address given in his recorded junior trust deed. The request calls for a copy of any NOD recorded under the senior trust deed identified in the request form to be sent to the carryback seller at the address of his place of business. [See Form 450 §11 in Chapter 14]

Later on, the carryback seller has another change of address, but this time he fails to record another Request for NOD. The buyer's loan payments to the senior lender become delinquent and he fails to bring the loan current.

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street
Address

City &
State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

REQUEST FOR NOTICE OF DEFAULT AND NOTICE OF DELINQUENCY

By Junior Trust Deed Beneficiary

Request for Notice of Default

Under Calif. Civil Code §2924b, request is hereby made for a copy of any Notice of Default (NOD) and a copy of any Notice of Sale under the Trust Deed recorded on ______________________________________,
as Instrument No. ____________________, Official Records of ______________________ County, California,
executed by ____, as the Trustor,
in which ____ is the Beneficiary, and
____ is the Trustee,
to be mailed to ____, as the Requester,
whose address is ____.

NOTICE: A copy of any Notice of Default and of any Notice of Sale will be sent only to the address contained in this recorded request. If your address changes, a new request must be recorded.

Request for Notice of Delinquency

Under Calif. Civil Code §2924e, request is hereby made for Notice of Delinquency (NODq) under the above described Trust Deed being a lien on property commonly referred to as ________________________________
____,
and being your Loan No. ________________, to be mailed to________________________, as the Requester,
whose address is ____.
Requester is Beneficiary under a Trust Deed recorded on ________________, as Instrument No. ___________,
in the Officials Records of ______________________________________ County, California, securing a note
which will be due____________, 20_____.

Consent of Trustor

As Trustor(s) under the above described Trust Deed, I/we hereby consent to this Request for Notice of Delinquency.
Trustor: __________________________________ Trustor: ______________________________________
(*Signature*) (*Signature*)

Date: _____________, 20______ Requester: ____
Date: _____________, 20______ Requester: ____

STATE OF CALIFORNIA
COUNTY OF____
On ____ before me,
____
(Name and title of officer)
personally appeared ____________________________________
____,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ____
(Signature of notary public)

(This area for official notarial seal)

The trustee records an NOD. A copy of the NOD is mailed to the carryback seller at his new address which was known and provided by the lender. The buyer cures the default during the reinstatement period.

Later, the buyer again becomes delinquent on his loan payments. An NOD and Election to Sell is again recorded on instructions from the same beneficiary, but by his use of a different, substitute trustee.

However, the lender does not provide the substitute trustee with the carryback seller's current address. The substitute trustee sends the NOD and Election to Sell, and later the notice of trustee's sales (NOTS), to the carryback seller's old address which was the last address of record. The notices are returned to the trustee by the postal service as undeliverable, and thus are never sent to the carryback seller at his new address.

The carryback seller learns of the NOD and the NOTS during the five business days preceding the date scheduled for the trustee's sale, after expiration of the reinstatement period. The carryback seller seeks to have the substitute trustee rescind the NOD and cancel the trustees's sale, claiming the failure to send him notice of the NOD and NOTS at his address known to the lender invalidates the foreclosure process.

Did the lender properly follow statutory mailing requirements?

No, the lender did not follow the statutory mailing requirements since it did not provide the foreclosing trustee with the carryback seller's current address, which was known to the lender. However, the substitute trustee did follow the statutory mailing requirements since he sent notification to the carryback seller at his last address of record and reflected in the sale guarantee issued by the title company.

When a beneficiary initiating foreclosure knows an interested party's current address (by correspondence with that address or otherwise), the beneficiary must advise the substitute trustee to mail the notice to that address.

If the trustee's sale does occur, money losses can be recovered by the junior lienholder from the beneficiary for failure to instruct the substitute trustee to mail the notice to the current address of the junior lienholder as known to the beneficiary. [**I.E. Associates** v. **Safeco Title Insurance Company** (1985) 39 C3d 281]

Documents of record often have outdated or incorrect addresses. However, foreclosure trustees themselves are not required to engage in further efforts to investigate **unrecorded information** to see if the notice is mailed to the most current address for the person entitled to notice. In an effort to protect all interested parties, the trustee should inquire into the beneficiary's knowledge of the current address of parties known to hold interests in the property.

Whenever an owner, carryback seller or tenant has a **change of address**, good practice requires that they record a new Request for NOD. When a new Request for NOD is recorded, the trustee foreclosing must send notices to the mailing address given in the new request for notice.

NODq protection

A recorded Request for Notice of Default (NOD) containing a current address assures a carryback seller he will be **sent notice** of the commencement of a trustee's foreclosure sale within 10 days after the NOD is recorded.

However, by the time a senior trust deed lender records an NOD, the loan is often several months in arrears. The amount needed to be advanced by the carryback seller to reinstate the loan may be economically infeasible after a long-standing, continuing default. Delays may occur before an NOD is recorded when lenders are overwhelmed with defaults during recessionary periods. These delays occasionally last a year or more.

Unable or unwilling to reinstate a hugely delinquent first trust deed, the carryback seller loses his second trust deed lien due to the senior lender's foreclosure on the property since it is wiped out, called *exhaustion of the security*.

The Request for Notice of Delinquency (NODq) assures the junior lienholder, who in this scenario is the carryback seller, that he will be notified when a delinquency in installments has existed for no more than **four months and 15 days**. [CC §2924e(c)]

Good brokerage practice when negotiating a carryback note or a private money loan, secured by a second trust deed, includes the buyer's or owner's consent to use a **Request for Notice** form which includes both the NOD and NODq requests. The same advice holds for leasing agents assisting tenants when entering into lease agreements. [See **first tuesday** Form 412 accompanying this chapter]

Recording and receiving a Request for NODq

A Request for Notice of Delinquency (NODq) may be recorded and served on a senior lender, if agreed to by a buyer or owner, when the secured property is:

- a one-to-four unit residential property; or
- any other type of real estate, but the senior lender need not respond by giving notice if his original loan was greater than $300,000. [CC §2924e(a)]

A Request for NODq must include the name and address of a carryback seller or private lender as the *requestor*, his security interest in the property as the beneficiary of a trust deed, and identification of the senior trust deed loan.

The buyer or owner must **consent** to the Request for NODq by signing it as the *trustor* before the lender is required to comply with the request. The consent to the Request for NODq should be bargained for as part of the terms negotiated for the carryback note or loan origination. [See **first tuesday** Forms 150 § 8.3 and 426 §7.6]

The written consent of the buyer or owner can be either in a separate document, such as the Request for Notice form, or included with the request in the body of the carryback trust deed. The latter is a complicated alternative since a copy of the trust deed containing the request must then be served on the senior lender. [CC §2924e(a)]

The properly prepared Request for NODq is served on the lender, together with a $40 fee, by regular mail addressed to the lender at the address where loan payments are received.

For example, if the carryback seller is secured by a third trust deed, the first and the second trust deed holders are each entitled to $40 on their receipt of the Request for NODq.

The Request for NODq is prepared, recorded and served on the lender by escrow under instructions from the buyer and the carryback seller. In the case of a loan escrow, the instructions are from the owner and the private lender. All costs to prepare and record the notice are paid by the buyer or owner.

The Request for NODq is **valid for five years** from the date it is mailed to the lender or recorded, whichever event occurs last. [CC §2924e(b)]

Prior to the five-year expiration of the Request for NODq, it may be **renewed** for five additional years by recording and mailing the senior lender a copy of the original Request for NODq, together with a written statement of renewal and a fee of $15. A renewal of the request may be sent no sooner than six months before the expiration date of the five-year period for the original request. [CC §2924e(b)]

Prompted by a Request for NODq from the carryback seller or private lender, the senior lender will send them a notice by regular mail within 15 days following a four month delinquency in the payments of any monies due the lender which remains unpaid. The notice will include the status of the delinquency and the amount required to cure it. [CC §2924e(c)]

Final considerations

The Request for NODq scheme, with its four month and 15 day delay before delivery of the notice of any delinquency, provides only limited protection. The carryback seller, private lender, or tenant must still maintain sufficient **money reserves** for multiple reasons, including:

- to cover future costs and advances required to reinstate the first trust deed on a default by the owner; and

- to carry the payments on the first trust deed (and any delinquent taxes and insurance premiums) until the carryback seller or private lender can complete a foreclosure or pre-foreclosure workout with the owner.

An additional and more fundamental protection for the carryback seller who is subordinate to a senior trust deed lien is to consider the use of an all-inclusive note and trust deed (AITD). As holder of an AITD, the carryback seller, not the buyer, is obligated to make payments on the first trust deed, provided the buyer pays the carryback seller on the AITD note. [See Forms 421, 442, and 443 in Chapter 34 and Form 450 in Chapter 14]

When an AITD is used, the need for information on delinquencies in underlying, wrapped loans is reversed between the buyer and the seller. It is now the buyer who needs to make the Request for Notice as the **requestor**. Without making the Request for Notice, the buyer will not receive early notice of a default on the first trust deed should the seller fail to meet his obligations under the AITD to make timely payments on the wrapped loan. The same consideration for an NODq must be given to a tenant's interest under a lease with the owner, since the owner implicitly agrees to do nothing to interfere with the tenant's leasehold interest in the property.

Chapter 49 Accepting partial payments after a default

This chapter discusses the lender's right to complete a foreclosure after receipt of an owner's partial payment toward delinquencies.

The lender may continue to foreclose

An owner of real estate encumbered by a trust deed lien loses his primary source of personal income. As a result, the owner is unable to make installment payments called for in the note secured by the trust deed. Negotiations with the lender to restructure the payment schedule in a pre-foreclosure workout are futile and the lender records a Notice of Default (NOD).

On receipt of the NOD, the owner tenders some of the delinquent payments referenced in the notice. However, he does not tender all delinquent installments and foreclosure charges required to *reinstate* the loan and rescind the NOD.

The lender accepts the owner's **partial payments**. Immediately after receipt of the partial payment, the lender sends the owner a letter that notifies him the loan is still in default, the amount needed to cure the default and bring the loan current, and that the property remains in foreclosure, since the owner's partial payments were insufficient to reinstate the loan.

The owner is also informed that the foreclosure will continue until the loan is brought current or the property is sold at a trustee's sale. Ultimately, a trustee's sale is set by posting and recording a Notice of Trustee's Sale (NOTS).

The owner challenges the validity of the NOTS, claiming the lender *waived its right* to complete the foreclosure by accepting the partial payment on the loan after recording the NOD.

The lender claims the foreclosure may proceed to the trustee sale since the owner paid only part of the amount noticed as delinquent in the NOD, and thus the loan remained in default at all times after the NOD was recorded.

Can the lender proceed with the foreclosure sale after accepting partial payments of the delinquent amount noticed in the NOD?

Yes! By accepting partial payments after recording an NOD and then promptly making a written demand on the owner for the additional amounts required to reinstate the loan, the lender **does not waive** its right to complete the foreclosure process. Only the owner's (or a junior lienholder's) **payment in full** of the delinquent amounts and foreclosure charges owed the lender will reinstate the loan. Thus, the lender is not required to rescind the NOD until all amounts noticed in the NOD are paid in full to reinstate the loan. [**Sellman** v. **Crosby** (1937) 20 CA2d 562]

A *non-waiver clause* in the lender's trust deed authorizes the lender to accept partial payments without waiving its right to foreclose since the note and trust deed have not been brought current and a debt remains. [**M.E. Hersch** v. **Citizens Savings and Loan Association** (1983) 146 CA3d 1002; see Form 450 §3.2 in Chapter 14]

Thus, if the lender accepts a partial payment, to clarify its right to continue with foreclosure it must immediately notify the owner regarding:

- the payment does not reinstate the loan, the owner still remains in default and the property is subject to being sold at a foreclosure sale;

- the dollar amount necessary to reinstate the loan and rescind the NOD; and

- the lender retains the right to complete foreclosure on the property if the amount remaining to be paid to cure the default is not tendered prior to the expiration of the **reinstatement period**. [**Hunt** v. **Smyth** (1972) 25 CA3d 807]

If the conduct of the lender leads the owner to believe the default has been cured, which might occur should the lender fail to notify the owner that the amount tendered is insufficient to bring the loan current, the lender will be barred from continuing with the foreclosure. [**Altman** v. **McCollum** (1951) 107 CA2d Supp. 847]

Additionally, when the trust deed contains an assignment of rents provision and the trust deed is in default, the lender is entitled to collect rents from the landlord or the tenants. Rents collected by the lender are then applied toward the amounts called for in the NOD to cure the default. The lender can continue with foreclosure on the real estate until the default is paid in full. [See Chapter 14]

Partial payment on an incurable default

A lender accepting regular installment payments from an owner when the default cannot be cured by a reinstatement of the loan waives its right to foreclose based on that default.

For example, a buyer acquires property which is subject to a trust deed containing a due-on-sale clause. The buyer tenders the regularly scheduled loan payments directly to the lender but does not obtain the lender's waiver of the due-on clause by formally assuming the loan.

The lender, on learning of the change in ownership, proposes a loan **assumption agreement** which would modify the terms of the loan in exchange for the lender waiving its right to call the loan. The buyer rejects the lender's offer. However, the buyer continues to make the regularly scheduled payments to the lender as called for in the note held by the lender. The lender accepts the buyer's payments without qualification.

A year later, the lender sends the buyer a letter *calling the loan* and informing the buyer their further acceptance of loan payments will not constitute a waiver of the call. The buyer fails to pay the loan in full following the call, thus prompting the lender to initiate foreclosure on the buyer's property.

In this example, the lender failed to **promptly enforce** its rights under the due-on-sale clause when it first learned of the transfer of ownership. The lender did not call the loan until one year after it had knowledge of the change in ownership. During that period it accepted regular loan payments from the buyer without first entering into a **Reservation of Rights** agreement.

Thus, the lender by its conduct with the buyer waived its right to enforce its due-on-sale clause on that transfer to the buyer by calling the loan. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

The lender's remedy for a violation of the due-on clause in a trust deed is limited to **calling the loan**. After making the call, the lender may attempt to negotiate a restructuring of the loan with the buyer, if that is its desire.

However, the lender must not accept payments after the call has been made (without first entering into a reservation of rights agreement). A loan which has been called under a due-on clause cannot be reinstated after the call unless the lender permits it, since the call leaves but one payment due in the form of a final/balloon payment.

Take the money and credit the loan

Some lenders return partial payments tendered by an owner after a default in regular monthly payments. But lenders are entitled to take the money and credit it to the amounts due. However, some lenders are under the mistaken belief that acceptance of the payment will bar them from completing their foreclosure on the property.

Lenders should always accept payments tendered by the owner when the owner has the **right to reinstate** the loan, unless the owner imposes a condition upon the tender with an endorsement on the checks regarding a *disputed amount*.

In an attempt to evade the lender's foreclosure rights, property owners occasionally place conditions on the check they tender, stating the amount of the check is intended to fully cure the default or constitutes a rescission of the notice of default (NOD). When this occurs, the lender is not required to accept the owner's *conditional tender*. [Calif. Civil Code §1494]

The lender can return the **conditional tender** and inform the buyer that only a full payment of the amount due will cure the default and terminate the lender's right to proceed with the foreclosure on the real estate.

Consider an owner of real estate who enters into a service contract employing a broker to obtain a lower property assessment for the current and the prior year.

The owner agrees to pay the broker a percentage of the tax savings received as payment for the services rendered. However, the owner believes he will only owe a percentage on one tax year's savings.

The broker obtains reduced assessments for the current and prior years. The owner pays for the broker's services based on the tax savings for only one year and writes an *endorsement* on the back of the check which states, "payment in full for all services."

The broker cashes the check without deleting the owner's **endorsement**. The broker promptly sends a letter to the owner stating the dollar amount of the check does not fully pay for all services performed and makes a claim on the owner for the remaining unpaid amount.

The owner claims the broker is barred from collecting any further amounts for his services since the check was deposited with "payment in full" printed on it.

The broker claims the acceptance of the check promptly followed by his notice to the owner that the amount was insufficient does not constitute payment in full.

Here, the broker's claim for the full payment of services is allowed since the broker promptly communicated with the owner that acceptance of the check did not constitute payment in full. [**In re Van Buren Plaza, LLC.** (1996) 200 BR 384]

Additionally, a lender might be improperly motivated to refuse to accept any partial payment from an owner until the loan is brought current, in an effort to trigger additional monthly late charges — a source of low-cost revenue.

Chapter 50 — A deed-in-lieu of foreclosure

This chapter reviews a trust deed holder's acceptance of a deed-in-lieu to avoid the delay and expense of a foreclosure.

Reducing the risk of loss

The trustee's foreclosure sale of property under a junior trust deed held by a creditor, such as a carryback seller or an equity lender, leaves the creditor unable to recover all the monies due on the note when an underbid is accepted or the property value is deficient to recover the loan amount. The same holds true for a first trust deed noteholder with a high loan-to-value ratio (LTV). [See Chapter 30]

Rather than first initiating a trustee's foreclosure when a property owner defaults during periods of declining property values, a prudent lienholder attempting to save the considerable costs and time lost by foreclosing under such economic conditions should consider negotiating with the property owner for a *deed-in-lieu* of foreclosure.

*Editor's note — The following deed-in-lieu rules also apply to the termination of the buyer's rights of redemption under **lease-options sales** and **land sales contracts**.*

The deed-in-lieu is an exchange

A **deed-in-lieu** is prepared on the same grant deed form used for the conveyance of fee title. [See Form 406 accompanying this chapter]

An owner of property who signs and delivers a deed-in-lieu essentially conveys his property to a carryback seller or lender **in exchange** for the seller or lender canceling debt; the debt evidenced by a note and secured by a trust deed lien on the property.

To complete the exchange, both the deed-in-lieu and a reconveyance of the trust deed are recorded. Thus, the lender-borrower relationship between the holder of the trust deed and the owner of the property is extinguished.

Before completing the exchange, the seller or lender negotiating for a deed-in-lieu of foreclosure must consider:

- title insurance;
- purchase options;
- due-on clauses;
- reassessment; and
- tax aspects of the transfer of title in exchange for cancellation of the debt.

Deed absolute vs. a mortgage

For a deed-in-lieu to function as a *deed absolute*, the transaction must be a **fair exchange** of values; a conveyance by the owner retaining no interest in a property for a trust deed holder's cancellation of a debt. Thus, the owner agrees to a deed-in-lieu of foreclosure when he has little or no measurable dollar amount of net equity in his property in excess of the liens.

Conversely, a deed-in-lieu does not function as a **deed absolute**, but as a *mortgage-in-fact* when the owner executing the deed-in-lieu retains rights to:

- cure his default and have the property reconveyed to him at a later date;
- receive a payment of surplus net proceeds if the lender later resells the property; or
- continue in possession of the property under a lease and purchase option. [See Chapter 19]

A voidable deed-in-lieu

A deed-in-lieu (or *quit claim deed*) handed to a trust deed holder in advance of a default is voidable and can be rendered unenforceable by the owner of the property who signed the deed. If the premature delivery of the deed-in-lieu to the trust deed holder is for the purpose of eliminating the owner's reinstatement and redemption rights under a lien on the property, which is usually the only reason for its existence, the deed-in-lieu will be *set aside* as **void**. [**Hamud** v. **Hawthorne** (1959) 52 C2d 78]

Occasionally, at the time a trust deed lien is recorded or later modified, a deed-in-lieu is concurrently entered into by the owner, then notarized and delivered unrecorded to the lender or carryback seller. The deed-in-lieu will be recorded when a default occurs. However, should the deed in lieu be recorded, it will function as a mortgage, not a conveyance. The recorded deed-in-lieu both replaces and extinguishes the existing trust deed. Thus, the deed-in-lieu becomes a *mortgage-in-fact* providing security for the debt owed under the note, and the debt is no longer subject to the trust deed as its security device.

The delivery of a deed-in-lieu in advance of a default is an *invalid waiver* of the **redemption rights** an owner holds under any debt secured by his real estate. Thus, if a default occurs after a trust deed lienholder has received a deed-in-lieu, and the lienholder then records the deed-in-lieu, the lienholder is forced to complete a judicial foreclosure to clear title in his name. Recording an ineffective deed-in-lieu creates a mortgage without the benefit of a trustee's foreclosure provision. [Calif. Civil Code §2889]

The need for title insurance

On recording a deed-in-lieu, a **title insurance** policy needs to be issued or endorsed to assure the lienholder who is taking title that the title conveyed is clear of liens or other types of encumbrances (easements) which might have attached to the property after the lienholder's trust deed was recorded. Also, the property may have been conveyed by the owner after the lienholder's trust deed was recorded.

When any encumbrance exists on a property which is **junior in time** to the foreclosing seller's or equity lender's trust deed, a deed-in-lieu conveys title subject to that encumbrance.

Thus, a carryback seller cannot accept a deed-in-lieu and reconvey his trust deed if **junior liens** or conveyances which affect title to the property have been recorded after his trust deed was recorded. If the

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street
Address

City &
State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DEED-IN-LIEU OF FORECLOSURE

DATE: _____________, 20______, at ____, California.

1. I/We, ____,

hereby quitclaim to ____

1.1 all of my rights, title and interest in the real property situated in ___________________ County, California,

referred to as ____

____

____

____.

2. This deed is an absolute conveyance in consideration for ____

____ and

2.1 the cancellation and release of all rights and obligations arising from the document

2.2 entitled ____, dated __________________,

2.3 entered into by ____, as the __________________, and

2.4 ____, as the __________________.

3. Grantor declares that this conveyance was freely and fairly made upon the consideration listed above, and no agreements exist, oral or written, except as contained in this deed, with respect to the described property.

Date: _____________, 20______ ____
(Print Name) (Signature)

Date: _____________, 20______ ____
(Print Name) (Signature)

STATE OF CALIFORNIA
COUNTY OF____
On ____ before me,
____
(Name and title of officer)
personally appeared ______________________________________
____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature ____
(Signature of notary public)

(This area for official notarial seal)

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title has been further encumbered or conveyed, the carryback seller must foreclose to eliminate these encumbrances and clear title to the property in his name (or the name of the high bidder at the trustee's sale).

Title insurance companies view a deed-in-lieu with suspicion, since the deed may be voidable. Thus, special wording is required to signify the deed is a true conveyance, not a **disguised mortgage** with a lease and option allowing the owner to recover title.

To be insurable, the deed-in-lieu must state the transfer was freely and fairly entered into by the owner for **adequate consideration**. The deed must also state the conveyance either fully or partially satisfies the debt. [See Form 406 accompanying this chapter]

Additionally, the title insurance company may require an *estoppel affidavit* from the owner, containing similar assurances that the deed-in-lieu is a **deed absolute**, not a **mortgage-in-fact**.

Incentive to stay or convey

An owner who defaults on a trust deed is more inclined to agree to deliver a deed-in-lieu of foreclosure when his gross equity in the property is less than 10% of the property's current fair market value. Additionally, the trust deed holder will take a loss on the foreclosure and resale of the property if the owner's equity is less than 10%, possibly even 15%, of the property's current fair market value.

However, when the owner has little or no equity to lose, the trust deed holder may need to offer some greater incentive beyond cancellation of the trust deed note in exchange for title to the property. One incentive the trust deed holder may offer for a deed-in-lieu is a relatively small amount of "move-out" cash — key money — which is acceptable to the owner, in addition to the lienholder erasing the debt.

The incentive to enter into a deed-in-lieu may also include non-cash considerations, such as an agreement which permits the owner to continue occupying the property after the conveyance solely as a hold-over tenant.

*Editor's note — An option to repurchase accompanying the right to retain possession of the property under a lease may not be granted to the buyer, as it would convert the deed-in-lieu into a **mortgage**. [Calif. Code of Civil Procedure §744; see Chapter 19 and 20]*

The trust deed holder must weigh his money expenditures necessary to complete a foreclosure against the amount of cash or other forms of consideration he might offer the owner in order to obtain a deed-in-lieu and possession of the property. It is the price paid to avoid a delay in repossessing the property. [See Form 406]

Due-on-sale triggered

For a junior lienholder, taking title to real estate by a deed-in-lieu has some of the same effects as receiving a trustee's deed on foreclosure, since both trigger any due-on-sale clauses in the senior trust deed.

Whether repossessing property by foreclosure or a deed-in-lieu, the junior carryback seller or equity lender must consider negotiating with the senior lender for a waiver of its due-on-sale enforcement rights before they reinstate the senior lender's trust deed loan. [See Chapter 28]

Profit reporting consequences

Unlike money lenders, carryback sellers who take back the property they sold, either by way of a trustee's sale or deed-in-lieu, cannot report a profit or loss on the exchange of the canceled carryback note for title to the property. The current value of the property is of no concern to the government for tax reporting purposes.

However, the tax consequence of the original sale in which the carryback paper was created is re-analyzed. Taxwise, any portion of the down payment and principal paid in the installments which were not previously taxed are now **taxed on repossession** of the property. [Internal Revenue Code §1038]

Reassessment by the county assessor

Whether a seller obtains title through foreclosure or a deed-in-lieu, a *change of ownership* occurs which calls for a reassessment of the property for determining local property taxes.

The property will be reassessed by the county assessor at its current market value on receipt of a deed-in-lieu or a trustee's deed.

Chapter 51 Trustee's or attorney fees, not both

This chapter presents the maximum amount of trustee's or attorney fees collectible during the different stages of a judicial or nonjudicial foreclosure of a trust deed lien.

The three-stage foreclosure period

A private lender makes a second trust deed loan to an owner of real estate. The amount of the loan equals 10% of the property's value. Together with the amount of the first trust deed loan, the property is encumbered with a total loan-to-value ratio (LTV) of 85%.

The lender is willing to accept the risk of a high LTV ratio on the property in order to receive a higher-than-market interest rate since he perceives the present real estate market to be dynamic enough to support a continuous rise in resale prices beyond the due date of the loan. Additionally, the owner has a significant and liquid net worth independent of his equity in the property.

The owner later defaults on the second trust deed. The private lender pursues recovery of his loan amount from the sale of the secured property by both:

- recording a **Notice of Default** (NOD) using a trustee to initiate a nonjudicial foreclosure; and
- filing a court action to initiate a judicial foreclosure.

No *specific performance action* is filed to appoint a receiver to enforce the collection of rents under the assignment of rents provision in the trust deed.

Prior to the sale of the property by either a judicial or nonjudicial trustee's foreclosure procedure, the private lender orders out an appraisal of the property to determine its present fair market value (FMV). Should the property's FMV be sufficiently high to cover the amount remaining due on the first and second trust deed loans and the costs of the property's resale, the trustee's sale will be completed and the judicial foreclosure action dismissed.

However, the appraisal may indicate the property's FMV is insufficient for the private lender to recover his entire loan balance plus accrued interest and foreclosure/resale costs from the value of the property. Should insufficient value exist, the lender will pursue a money judgment against the owner under the judicial foreclosure action for the deficiency in the property's FMV to cover the debt. On the sale of the property under the judicial foreclosure action, the lender will abandon the trustee's foreclosure by rescinding the NOD.

Prior to entering a foreclosure decree in the judicial foreclosure action, or the expiration of the reinstatement period in the trustee's foreclosure, the owner locates investors who join him as co-owners of the property, contributing capital to fund a reinstatement of the loan.

With the additional capital from the investors' funds, and prior to the expiration of either reinstatement period, the owner tenders the amount owed to reinstate the loan, consisting of:

- the delinquent payments of principal and interest;

- the late charges properly noticed and accounted for;
- any advance made by the lender;
- any delinquent property taxes; and
- trustee's fees provided by foreclosure statutes. [Calif. Civil Code §2924c]

The lender refuses tender of the money, claiming the tender of no more than the **statutory trustees's fees** is insufficient to reimburse the lender for handling the NOD and notice of trustee's sale (NOTS) and attorney fees incurred to litigate the judicial foreclosure action (which collectively exceed the statutory ceiling on foreclosure fees chargeable by trustees or attorneys).

The lender claims the reinstatement statute is unreasonable and should not apply to attorney fees in a judicial foreclosure action, since reasonable fees far exceed the statutory limits set for attorney fees collectible in foreclosure actions.

Is the lender limited to accepting the amount of the statutory ceiling for the total of both the trustee's fees and attorney fees, despite the fact that reasonable attorney fees in the foreclosure action run far in excess of the statutory limit?

Yes! The owner tendered the correct amount to bring the loan current before entry of a foreclosure decree in the judicial action or commencement of the five business day redemption period prior to a trustee's sale. Thus, the loan was reinstated, and no longer in default, by tender of the statutory maximum trustee's fees and all other delinquencies on the loan. The lender's collection of attorney fees incurred to **litigate the judicial foreclosure**, in addition to the trustee's fees, are prohibited since attorney fees are controlled by the statutory limit on both trustee's fees and attorney fees. [**Bruntz** v. **Alfaro** (1989) 212 CA3d 411]

While a double set of fees was reasonably incurred by the lender, the lender is unable to collect both the trustee's fees and the attorney fees from the owner. One or the other is permissible, but not both.

Time periods during foreclosure

The maximum amount of trustee's fees and attorney fees a foreclosing lender may recover in a judicial or trustee's foreclosure proceeding is set depending on the stage of the foreclosure proceeding. The foreclosure stages proceeding the sale of the property are different from the reinstatement and redemption periods following the commencement of a foreclosure. [See Chapter 45]

The lender may foreclose on secured property by filing a judicial action or by instructing the trustee to record a notice of default (NOD), or by initiating both remedies concurrently as previously demonstrated.

If a **lender completes** one of the foreclosure procedures, the lender's other foreclosure procedure is then eliminated. However, commencement of one foreclosure remedy without completion by a foreclosure sale does not preclude the commencement and completion of the other. [**Vlahovich** v. **Cruz** (1989) 213 CA3d 317]

Strategically, lenders may commence foreclosure by both recording a trustee's NOD and filing a judicial foreclosure action. However, **costs recoverable** on the double foreclosure, as distinguished from trustee's fees and attorney fees, are also limited to only one set of costs.

Simultaneous foreclosures

Lenders initiating a foreclosure on a **recourse loan** should consider promptly beginning a trustee's sale by immediately recording a notice of default (NOD) on default to expedite the sale of the property. A delay always works to the disadvantage of the lender.

Then, an appraisal of the property's fair market value (FMV) should be obtained before completing the foreclosure to determine whether the property's value is sufficient to recover the loan amount and related costs. [See Form 303 accompanying this chapter]

If the property's value is insufficient to satisfy the recourse debt and foreclosure/resale costs, the lender needs to then consider delaying the setting of the trustee's sale and filing a judicial foreclosure action to *obtain a decree* ordering the property to be sold by a sheriff.

By resorting to a judicial foreclosure sale and abandoning the trustee's foreclosure, the lender holding a recourse loan is able to pursue a money judgment for any deficiency in the property's FMV at the time the property is sold at the judicially ordered sheriff's sale.

If the value of the property increases prior to the judicial foreclosure sale, or the lender wishes to expedite foreclosure of the property, the trustee's sale can be held and the judicial action can be dismissed.

However, lenders who foreclose by initiating concurrent trustee's and judicial foreclosure proceedings cannot collect the fees incurred to prosecute both foreclosure proceedings when the property owner reinstates the loan or redeems the property by payment in full.

Attorney fees are only collectible in an action for **judicial foreclosure** at two times:

- on the owner's reinstatement of the note and trust deed prior to the foreclosure decree, in the amount allowed by statute for trustee's fees or attorney fees; or
- on completion of the judicial foreclosure, in an amount deemed reasonable by the court. [CC §2924c(d); Calif. Code of Civil Procedure §726(a)]

However, on reinstatement of the loan, the trustee in the concurrent trustee's foreclosure will rescind the recorded NOD and demand payment of trustee's fees from the lender. In the process of reinstatement, the lender will be reimbursed for the trustee's fees but not for the attorney fees. Only the statutory fees are permitted to be recovered by the lender as reimbursement from the property owner.

If the owner fails to reinstate the note and the lender sells the property in a trustee's foreclosure sale, the lender will only recover fees expended for foreclosing nonjudicially. A lender will not be allowed to recover the attorney fees incurred in a concurrent judicial foreclosure action, since if it was allowed, the lender would receive a double recovery of foreclosure fees.

Statutory limits on fees

When a debt secured by real estate is in default and the debt is reinstated during foreclosure, the trust deed holder is limited by statutory fee schedules to reimbursement of a maximum amount for trustee's or attorney fees.

The owner or junior lienholder may **reinstate** a defaulted trust deed lien prior to the earlier of:

- entry of a foreclosure decree in a judicial foreclosure action; or
- five business days before the date set for the trustee's sale. [CC §2924c(e)]

The **foreclosure fee schedule** for trustee's fees (or attorney fees) recoverable by a lender during the stage of a trustee's foreclosure following the recording of a notice of default (NOD) and before recording a notice of trustee's sale (NOTS), is limited to:

- $300 for the first $150,000 of the loan balance; or
- $250 for loans exceeding $150,000 of the loan balance; plus
- 0.5% of the unpaid principal between $50,000 and $150,000; plus
- 0.25% of the unpaid principal between $150,000 and $500,000; plus
- 0.125% of the unpaid principal balance exceeding $500,000. [CC §2924c(d)]

However, after an NOTS in a trustee's foreclosure has been deposited into the mail, the trustee's fee schedule for the maximum trustee's fee changes. The trust deed lender during the **NOTS stage**, which ends with the completion of the trustee's sale of the property, can recover fees limited to:

- $425 if the loan balance is $150,000 or less;
- $360 if the loan balance exceeds $150,000; plus
- 1% of the unpaid principal balance between $50,000 and $150,000; plus
- 0.5% of the unpaid principal balance between $150,000 and $500,000; plus
- 0.25% of the unpaid principal balance exceeding $500,000. [CC §2924d(a)]

When the property is sold at a **trustee's sale**, the maximum increase in statutory trustee's fees or attorney fees is limited to the greater of:

- $425; or
- 1% of the principal balance on the date of the NOD, whichever amount is greater. [CC §2924d(b)]

For **judicial foreclosures**, attorney fees are fixed at the NOD fee schedule for reinstatement until entry of the *foreclosure decree*. As part of the **foreclosure decree**, attorney fees can be awarded for legal services rendered in excess of the statutory limits, so long as a court deems them reasonable. Unless a deficiency is awarded, the extra fee incurred to litigate the judicial sheriff's sale should not be awarded since a trustees sale accomplishes the same end result in less time (and for less money). [CCP §580c]

Attorney fees unrelated to foreclosure

Often, a trust deed lender is required to file a lawsuit to defend his security interest as a lien on title or in maintaining the value of a property. The litigation is separate from any judicial or trustee's sale foreclosure procedures which may be concurrently in process. The attorney fees expended in a separate action are unrelated to the trustee's fees or attorney fees expended to foreclose. Defending the trust deed lender's security interest is not a foreclosure action.

For example, consider an owner who defaults on a trust deed containing an attorney fees provision. The lender initiates a trustee's foreclosure. In response, the owner files a law suit to stop the foreclosure. The owner claims the foreclosure was commenced solely to satisfy the lender's desire to acquire the real estate for investment purposes during a real estate recession at a time when it is impossible for the owner to realize the property's full value by selling it now.

The lender prevails and is allowed to continue with the trustee's foreclosure. In the process, out-of-pocket costs and attorney fees have been incurred by the lender to defend his right to foreclosure on the property.

The attorney fees awarded in the judicial action are added to the property owner's loan balance by the lender as a **future advance** authorized by the trust deed. On a reinstatement demand requested by the owner, the lender requires the attorney fees be paid before the owner can bring the loan current.

The owner claims the attorney fees are limited under reinstatement laws since the lender's attorney fees were incurred during the reinstatement period.

Can the lender collect the full amount of its award for attorney fees incurred in the non-foreclosure action?

Yes! The attorney fees were incurred in litigation initiated to protect the lender's trust deed rights, not to initiate and litigate a judicial foreclosure. Accordingly, and in addition to trustee's fees, the lender can collect the award for attorney fees under the attorney fees provision in the trust deed. The attorney fees are limited to a reasonable and necessary amount. [**Buck** v. **Barb** (1983) 147 CA3d 920]

Attorney fees paid by the lender are considered **future advances** when the fees are incurred to protect the lender's security interest in the property and the fees are secured by the property under the terms of the trust deed. [**Bisno** v. **Sax** (1959) 175 CA2d 714; see Form 450 §§1.3d, 2.3 and 2.5 in Chapter 14]

SECTION H

Tax Aspects of Financing

Chapter 52 Deductions of points by homebuyers

This chapter discusses the income tax deductions a homebuyer or homeowner may take for the loan points and origination fees incurred on a refinance, purchase-assist or improvement loan.

Prepaid interest write-off exception

Interest on a loan **accrues daily** over the life of the loan. In contrast, a lender's penalty charge (bonus) accrues in its entirety on the occurrence or failure of an event, as with a prepayment penalty or a late charge.

Taxwise, **interest**, no matter the form it may take, which has accrued and been paid on a loan can be written off when determining income tax liability if the interest qualifies as either an *expense* or *deduction* from income.

For example, *accrued interest paid* on a loan, the proceeds of which funded a person's **trade or business activities**, is written off as an *operating expense* of the person's business.

Conversely, **accrued interest paid** on a loan that funded the purchase, improvement or carrying costs of a **rental property** is not an **operating expense** incurred by the property. Thus, mortgage debt on a rental property is not considered when establishing the property's net operating income (NOI). However, interest is written off as a **deduction** from the NOI produced by the rental property (which is also the depreciation allowance). [See **first tuesday** Form 352]

Somewhat different from accounting for interest on a business or rental property, accrued interest paid on a loan that funded the purchase, improvement or carrying costs of **portfolio property** held for long-term profit (such as ground leases, management-free, triple-net leases or land held for profit on resale), is written off as a **deduction** against any income and profit from all sources within the portfolio income category.

Then, the income or loss within each of the three different income categories is calculated independent of each other category. As a result, the reportable income or loss within one category is not commingled with income from any other category.

In contrast to loans for business, rental or portfolio purposes, home loans are treated differently. A loan that funds the purchase or improvement of an owner's **principal residence** or **second home** is a *personal use loan*. Accrued interest paid on personal use loans is not tax deductible, with some exceptions. One exception to the non-deductibility rule is interest paid on loans **made in connection with** the principal and second residence beyond providing security for payment of the loan.

Under the **non-deductibility exception**, interest accrued and paid on the first and second home loans is written off as a deduction once the owner's adjusted gross income (AGI) has been set. Thus, the home loan interest becomes part of the schedule A *itemized deductions* from AGI which directly reduce the homeowner's taxable income, not his adjusted gross income. Thus, the amount on which he will pay taxes is reduced.

Editor's note — The greater an individual's AGI, the smaller the total amount of allowable deductions. Itemized deductions on schedule A are phased out for the year as the AGI increases. Eventually, only as little as 20% of the total itemized deductions remains, which includes home loan interest.

The phaseout for 2007 begins for a married couple filing a joint return at a projected threshold of $156,400 in annual gross income. Thus, the total amount of the itemized deductions is reduced by 3% of every dollar the owner reports in AGI over the threshold. For example, if the itemized interest paid is $25,000 and the AGI (in 2007) exceeds $156,400 by $100,000, $3,000 of the $25,000 will be disallowed.

The government *subsidizes* homeownership through interest deductions on home loans which reduces the taxes the homeowner is required to pay. The amount of tax savings range from 10% and 15% for low-income homeowners, to 35% for high-income homeowners on the amount of interest they pay. Thus, the wealthier one is, to a point, the greater the subsidy for homeownership. Limitations on wealthier homeowners are imposed by the itemized deductions phase out and the alternative minimum tax (AMT) restrictions on allowable deductions.

Wealthier homeowners who are subject to the AMT and have encumbered their first or second home with an equity loan or refinancing (and have used the net proceeds for purposes other than the improvement of, or in connection with, the first or second home) are not allowed to deduct the interest paid on these loan amounts which are not connected to the purchase or improvement of the first and second home. [Internal Revenue Code §56(e)(1)]

The sole basis for allowing the personal interest deduction for a mortgage on a first and second residence is the **federal policy** of encouraging homeownership. The social policy is propagandized by the use of the slogan "The American Dream" and implemented through tax incentives and implicit guarantees for loans held by federally chartered lenders such as Freddie Mac or Gennie Mae. The reasons behind the

Home ownership through tax incentives

Income tax law is often used as a tool by the federal government for social engineering. The social purpose for allowing immediate deduction of points is to encourage renters to purchase homes.

However, a tenant compares the amount of his rent payment with the amount of his potential house payment when deciding to take on the status of homeowner. Since the house payment for new homeowners is typically greater than rent in California, the encouragement has little effect.

While the deduction of loan origination points is financial aid during the new homeowner's first year of increased living costs, the homeowner's tax relief in the following years is limited only to the interest included in the monthly payments and property taxes paid.

However, the deduction of points in the year of closing is more effective in inducing sustainable long-term home ownership than other tax incentives. The deduction of points is not a direct subsidy designed to bail out builders and REO lenders, such as a tax credit for buying a newly constructed home. Tax credits often encourage financially unprepared buyers to purchase homes, shifting the risk of ownership from overextended lenders and builders to homeowners.

federal policy are that homeowners generally require less government assistance in their elder years and make more responsible local citizens.

The points of interest

Points paid to a lender to originate a loan are considered *prepaid interest* since points are interest, and the interest has not yet accrued. Points essentially buy down the loan's *par rate* for the life of the loan to the interest rate denominated in the note. No points means a higher *nominal interest rate* will be stated in the note.

As **prepaid interest**, only the fraction of the points paid which accrues each month over the life of the loan, called the *life-of-loan accrual*, may be deducted against that year's income, with exceptions. When the loan amount is fully prepaid, any remaining unaccrued prepaid interest can then be deducted.

As an exception to the **life-of-loan** accrued reporting, the entire amount of the points paid on loans that assist in the purchase or improvement of an individual's **principal residence** (not a second home) is allowed as a *personal deduction* in the year the loan originated. The immediate deduction for all points paid in connection with a loan that finances the purchase or improvement of the taxpayer's primary home is another government subsidy, part of the overall policy to encourage homeownership in lieu of renting. [IRC §461(g)(2)]

The points deduction exception for a principal residence does not include points paid on loans secured by second homes or vacation residences.

Further, the deductibility of the loan points in the year paid, instead of over the life of the loan, depends on **who paid the points**— the buyer, the seller or the lender.

For example, a homebuyer applies for a loan to fund the purchase of property he will occupy as his principal residence. The loan will be secured by the residence. The lender will be paid points (prepaid interest) for making a purchase-assist loan at an interest rate below the **par rate** for the loan. The lender will not withhold the points from the loan proceeds (as a discount) or add them to the loan balance.

The points will be paid by either the homebuyer from his separate funds, or by the seller, under the terms negotiated by the buyer and his agent in the purchase agreement.

In this situation, the homebuyer can write off the points paid to the lender as a **current deduction** from his adjusted gross income (AGI), since:

- the loan proceeds are used to **purchase or improve** the borrower's principal residence;
- the loan is **secured** by the principal residence, with or without any additional security;
- the Uniform Settlement Statement (USS) accounts for the points paid as "points," "loan origination fees," "loan discount" or "discount points", and compute them as a percentage of the loan;
- the points were paid by the seller or from the buyer's separate funds, not as a discount or add-on by the lender;
- the payment of points is an established business practice of lenders in the area; and
- the points paid do not exceed the amount of points generally charged in the surrounding area. [Revenue Procedure 92-12]

Deductible points

To deduct the points in the year they are paid, the purchase-assist or improvement loan must be **secured by** a buyer's or homeowner's principal residence.

When the loan is secured solely by property other than the residence purchased or improved with the loan funds, such as business or rental property owned by the homeowner or others, the points must be deducted over the life of the loan.

Likewise, points paid by a buyer to finance the purchase or improvement loan for a **second residence** must be deducted as they accrue over the life of the loan. For example, points paid on a purchase-assist loan for a vacation home, payable monthly with a 30-year amortization, will be deductible 1/360th for each month of the tax year as the prepaid interest accrues.

Now consider the homeowner who obtains a home improvement loan secured by his **principal residence**.

The homeowner pays 2½ points on the loan from his separate funds. One of the points is called a *loan origination fee* and is a competitive amount.

Here, the points, even when they are called loan origination fees, are considered prepaid interest. An origination fee is fully deductible if the fee is **based on a percentage** of the homeowner's loan amount.

The owner also pays loan charges itemized by the lender to include administrative fees, processing fees, appraisal fees, title expenses and mortgage insurance premiums (MIPs).

Can the owner also deduct these itemized lender charges in the year they are paid?

No! These itemized charges reimburse the lender for **costs incurred** to originate the loan. Lender costs reimbursed by the borrower are not considered prepaid interest and are not deductible either at the time paid or over the life of the loan. [IRC §163; Rev. Proc. 94-27]

Loan costs incurred by the lender and paid by the owner on any type of real estate to originate a purchase or improvement loan are *capitalized* by the owner. Thus, loan costs are added to, and become part of, the owner's **cost basis** in the property and are not deducted or expensed as interest. Loan charges are non-recurring costs incurred to acquire or improve property, not daily recurring interest which can be expensed or deducted as it accrues and is paid or was prepaid. [**Lovejoy** v. **Commissioner of Internal Revenue Service** (1930) 18 BTA 1179]

Capitalized costs for originating a loan on property other than the first and second home are partly recovered by annual depreciation deductions, and fully recovered when the property is sold.

Seller-paid points

Consider a homebuyer who lacks sufficient funds or incentive to pay the points required to originate a home loan. During the buyer's negotiations with a seller, and as a provision in his offer to purchase the property, the seller agrees to pay the points so he can sell the property to the buyer.

In this instance, the homebuyer is allowed to deduct the points paid by the seller to assist the buyer in originating a purchase-assist loan. When the **seller pays the points**, the homebuyer is considered to have received **cash back** from the seller in the amount of the points. The cash is then used to pay the points as though the cash had come from the buyer's *separate funds*. [Rev. Proc. 94-27]

However, when the seller pays the points and the buyer deducts the amount as prepaid interest, the buyer's *cost basis* in the residence must be adjusted to reflect a **reduction in the price paid** by the dollar amount of the seller-paid points. The seller who paid the points expenses the amount as part of his costs of the sale, not as interest paid by the buyer's use of the cash. This tax treatment for the seller makes a financial difference if he is selling his principal residence at a loss, since if it is interest, he can deduct it, and if it is costs of a sale, he cannot take a loss.

Lender-paid points

Consider a homebuyer who lacks sufficient funds to pay the points demanded by a lender for the interest rate sought on a 30-year purchase-assist loan. Additionally, the seller refuses to pay any of the points without first renegotiating the purchase price of the property.

The lender agrees to increase the loan amount and withhold the points from the loan proceeds as a **discount**.

Can the homebuyer deduct the points paid from the loan proceeds in the year the points are paid from loan funds?

No! The homebuyer did not pay the points from separate funds, either his own or funds he received from the seller. The points were paid as a discount, or an add-on, to the loan. The points, being prepaid interest withheld by the lender, must be deducted annually as they accrue over the 360-month life of the 30-year loan.

Deduction of points on refinancing

Consider a homeowner who refinances the existing purchase-assistor improvement loan on his principal residence and pays the points for the refinancing from his separate funds.

Here, the **refinancing** did not fund the purchase or improvement of the residence, even though it funded the payoff of a purchase or improvement loan. Thus, the points on a refinance are annually written off as they accrue monthly over the life of the loan.

However, if a homeowner uses the **excess loan proceeds** from refinancing to make home improvements, a pro rata share of points paid from the homeowner's separate funds (equal to the percentage of the loan funds which paid for improvements) can be deducted in the year the homeowner refinanced his personal residence. [Revenue Ruling 87-22]

When the homeowner sells his residence or refinances again, the unaccrued points remaining on the existing loan are reported (with itemized deductions) as interest paid in the year of the sale, whether the loan is paid off or assumed by a buyer.

Consider a different homeowner who refinances his principal residence to reduce his monthly payment by $500. The monthly savings are then spent on home improvements, such as a roof replacement and remodeling of the kitchen and bathrooms.

The homeowner deducts all the points he paid for refinancing in the year he refinanced as an itemized deduction on his federal income tax return. He claims the refinancing freed up money for the improvements and was thus a property improvement loan.

The Internal Revenue Service (IRS) disallowed the deduction, claiming the refinancing merely funded the payoff of an existing loan on the property with no net loan proceeds for any improvements.

In this scenario, the deduction of all the points paid to refinance the existing loan is permitted. The refinancing was a loan the homeowner incurred **in connection with the improvement** of the property. The reduction in payments caused the homeowner to have funds to pay for the improvements he then made on the property. [Tax Court Summary Opinion 2005-125 (non-precedent)]

Refinancing short-term financing

A homebuyer executes a short-term note with a three-year balloon payment to help finance the purchase of his principal residence. The short-term note, which is secured by the residence, is a sort of swing loan which must be refinanced if the buyer is to continue his ownership of the residence as intended.

When the note becomes due, the homebuyer obtains permanent long-term financing. The short-term note is paid off with the proceeds of the permanent financing.

The homebuyer deducts the entire amount of the points paid on the long-term refinancing in the year paid. He claims the permanent financing was part of his original scheme to finance the long-term ownership of his principal residence, and was not mere refinancing.

The Internal Revenue Service (IRS) claims the homebuyer cannot deduct the points paid on the permanent financing since, to be entitled to an immediate deduction as a loan made in **connection with the acquisition** of the principal residence, the points must be paid on a loan made to directly fund the actual purchase or improvement of the principal residence.

Here, the points paid on the long-term refinancing of a short-term balloon payment note are deductible in their entirety in the year the points are paid.

The existence of a **short-term due date** in the note originated as a purchase-assist loan was evidence that the homebuyer contemplated refinancing the short-term note to retain the residence for long-term ownership. [**Huntsman** v. **Commissioner of Internal Revenue** (8th Cir. 1990) 905 F2d 1182]

The long-term loan, while it did not directly fund the purchase of the residence, was obtained **in connection with the purchase** of the residence. The refinancing occurred within the original term of the short-term balloon payment note, which by its nature compelled the refinancing.

Any indebtedness incurred in connection with the purchase or improvement of the homeowner's principal residence qualifies the points incurred to originate the loan for immediate deduction in the year paid. [IRC §461(g)(2)]

Chapter 53 Home loan interest deductions

This chapter reviews the home loan interest deduction for reporting the tax consequences of financing first and second homes.

Two residences, two deductions

The federal government has a long-standing policy of encouraging **residential tenants** to become homeowners. The incentive provided by the government to individual tenants is in the form of a significant reduction in the income taxes they will be required to pay if they **finance the purchase** of a residence or a vacation home.

For a residential tenant considering his income taxes, the monthly payment on a purchase-assist home loan is not just a substitute for his monthly rent payment, it also reduces his combined state and federal taxes by an amount equal to 20% to 30% of the monthly loan payment.

Real estate agents handling the sale or purchase of single family residences must be able to intelligently discuss this tax reduction incentive with residential tenants if the tenants are to be persuaded to buy based on the full range of homeownership benefits.

Due to the special home loan interest deduction rule for income tax reporting, the interest *accrued and paid* on loans is deductible from income as an itemized expense if:

- the loans funded the **purchase price** or paid for the **cost of improvements** for the owner's principal residence or second home; and
- the loans are secured by either the owner's **principal residence** or **second home**. [Internal Revenue Code §163(h)]

Without the home loan interest deduction rule, interest paid on a loan which funded the purchase or improvement of a principal residence or second home is not deductible. If the loan did not fund the purchase or improvement of the principal residence or other *personal expense*, it funded the acquisition of an investment or business property.

Also, interest paid on **equity loans** secured by the property owner's principal residence or second home is tax deductible under the home loan interest deduction rules, whether or not the loan's net proceeds were used for personal or investment/business purposes.

The loan interest deductions for the first and second home reduces the property owner's taxable income as an *itemized deduction* under both the standard income tax (SIT) and the alternative minimum tax (AMT) reporting rules. In contrast, the real estate **property tax deduction** on the first and second homes applies only to reduce the owner's SIT, not his AMT.

Two categories of loans exist to control the deduction of interest paid on any loans secured by the principal residence or second home, which include:

- interest on the balances of *purchase or improvement loans* up to a combined principal amount of \$1,000,000; and

- interest on all other loan amounts up to an additional \$100,000 in principal, called *home equity* loans.

Purchase/improvement loans

Interest paid on money loans and carryback credit sales originated to **purchase or substantially improve** an owner's first or second home is fully deductible on combined loan balances of up to \$1,000,000 for an individual and for couples filing a joint return if the loan is secured by either home. The loan balance is limited to \$500,000 for married persons filing separately.

Thus, if the loan funds are used to acquire, construct, or further improve a principal residence or second home, and the loan funds, collectively exceed \$1,000,000, only the interest paid on \$1,000,000 of the purchase and improvement loan balances is deductible as purchase/improvement interest. However, interest paid on the excess loan amounts, up to an additional \$100,000, qualifies for a deduction as interest paid on a home equity loan.

To qualify home improvement loans for interest deductions, the new improvements must be *substantial*. Improvements are **substantial** if they:

- add to the property's market value;
- prolong the property's useful life; or
- adapt the property to residential use.

Loan funds spent on repairing and maintaining property to keep it in good condition do not qualify as funding for substantial improvements. [IRC §163; Temporary Revenue Regulations §1.163-8T]

Refinancing limitations

If an owner **refinances** a purchase/improvement loan, the portion of the refinancing used to fund the payoff qualifies as a purchase/improvement loan for future interest deductions. However, interest may only be written off as a purchase/improvement loan on the amount of refinancing funds used to pay off the **principal balance** on the existing purchase/improvement loan.

For example, consider an owner who borrows \$200,000 to fund the purchase of his principal residence. The loan balance is paid down to \$180,000 and the owner refinances the residence, paying off the original purchase/improvement loan. However, the new loan is for a greater amount than the payoff demanded on the old loan.

In this scenario, interest on only \$180,000 of the refinancing is deductible as interest paid on a purchase or improvement loan, unless:

- the excess funds generated by the refinance are used to improve the residence; or
- the excess loan amount qualifies as a home equity loan under its separate ceiling of \$100,000 in principal.

$100,000 home equity loans

Interest on loan amounts secured by the first or second home may not qualify for the purchase/improvement home loan interest deduction, due either to a different use of the loan proceeds or the $1,000,000 loan limitation. However, the interest on loan amounts which are secured by the first or second residence and do not qualify as purchase/improvement loans is deductible by individuals and those couples filing joint returns as interest paid on additional or other loan amounts up to $100,000 in principal, called *home equity loans*.

For married persons filing separately, the cap for the principal amount of equity loans on which interest can be deducted is limited to $50,000, half of the joint $100,000 ceiling. [IRC §163(h)(3)(C)(ii)]

Home equity loans are typically junior encumbrances, but also include proceeds from a refinance which do not qualify as purchase/improvement funds and purchase/improvement loan amounts which exceed the $1,000,000 ceiling.

The proceeds from home equity loans may be used for any purpose, including personal uses unrelated to the property.

Property value ceiling

Interest paid on any portion of a loan balance which exceeds the *fair market value* of a residence is not deductible. In practice, the fair market value rule applies almost exclusively to home equity loans, including refinancing proceeds of a greater amount than the balance paid off on the purchase/improvement loan that was refinanced. [IRC §163(h)(3)(C)(i)]

The **fair market value** of each residence is presumed to be the original amount of the purchase price plus any improvement costs. Thus, any **future drop in property value** below the balance remaining on purchase-assist loans does not affect the interest deduction. [Temp. Rev. Regs. §1.163-10T]

Editor's note — Consistent with its policy under codes such as §1031, the Internal Revenue Service (IRS) does not perform any appraisal activities. Thus, the IRS has substituted the easily computable original cost of purchase and improvements for the fair market value limitation established by Congress. However, an owner who takes out a home equity loan which, when added to the other loan balances on the residences, exceeds his purchase and improvement costs of the property, can rebut the IRS fair market value presumption of cost with a current fair market value appraisal provided by the lender.

Thus, on a refinance or origination of a home equity loan, it is advisable for an owner to request and receive a copy of the lender's appraisal to later corroborate the property's increased market value at the time the financing was originated. [See ***first tuesday*** *Form 329]*

Qualifying the principal residence and second home

To qualify for a home loan interest deduction, loans must be secured by the principal residence or second home.

A *principal residence* is defined as an individual's home where the homeowner's immediate family resides a majority of the year, which is close to the homeowner's place of employment and banks which handle the homeowner's accounts, and the address of which is used for tax returns. [IRC §163(h)(4)(A)(i)(I)]

A *second home* is any residence selected by the owner from year to year, including mobile homes, recreational vehicles and boats.

If the second home is **rented out** for portions of the year, the interest qualifies for the home loan interest deduction if the owner occupies the property for more than 14 days or 10% of the number of days the residence is rented, which ever number is greater. [IRC §280A(d)(1)]

If the owner does not rent out his second home at any time during the year, the property qualifies for the home loan interest deduction whether or not the owner occupies it. [IRC §163(h)(4)(A)(iii)]

The rental income on the second home is *investment/portfolio income* if the home qualifies for the interest deduction due to the owner's days in occupancy exceeded the 14-day/10% rule.

If the second home has been rented, but the owner's family occupied the property for more than 14 days or 10% of the days rented thus qualifying the home for the loan interest deduction, the owner is not allowed to treat the property as an investment. Since the property is not an investment, the owner cannot depreciate the home. [IRC §§163(h)(4)(A)(i)(II); 280A(d)(1)]

A second home, when purchased for personal use and held for a profit on resale, also qualifies as investment (like-kind) property for exemption from profit taxes under IRC §1031. [IRC §1221; IRS Private Letter Ruling 8103117]

Taking the deductions

Interest deductions on home loans are only allowed for interest which has **accrued and been paid**, called *qualified interest*. [IRC §163(h)(3)(A)]

Interest on first and second home loans is deducted from an owner's **adjusted gross income** (AGI) as an *itemized deduction*. Further, limitations exists on the total amount of all deductions the homeowner can claim. Conversely, business, rental or investment interest are adjustments that reduce the AGI. Thus, the two types of home loan interest deductions directly reduce the amount of the owner's taxable income (if the interest deductible is not limited by ceilings on the homeowner's itemized deductions).

The inability to reduce the owner's AGI by use of the home loan interest makes a substantial difference for high income earners. The higher an owner's AGI, the lesser the amounts allowed for rental loss deductions, *itemized deduction phaseout* (starting at an AGI of $150,500 for 2006), and any tax credits available to the owner. [IRC §163(a), (h)(2)(A)]

Consider a homeowner who wants to generate funds to use as a down payment to purchase business, rental or investment real estate. His only substantial asset is the $300,000 equity in his home.

If the owner further finances with a home equity loan or refinances the existing loan to net $200,000 in loan proceeds, he will be paying interest which is only partially deductible. The non-purchase/improvement loan amount exceeds the $100,000 home equity loan cap. The interest the owner pays on the portion of home equity loan balance in excess of the $100,000 loan cap is not deductible under the home loan interest deduction rules.

The home as additional security

Consider a homeowner who encumbers the equity in his home to secure a note he executes as the down payment on the purchase of investment property.

The homeowner wants to avoid the home loan interest deduction limitations and be able to write off all the interest paid on the note against future income from the rental or portfolio property he purchased with the loan funds. Accordingly, the homeowner negotiates with the lender or carryback seller for the note to be secured by **two separate trust deeds**; one as a lien on the home and the other as a lien on the property purchased.

The lender or carryback seller is satisfied with the financial risk regarding the loss of principal. The lender or carryback seller receives a trust deed on the home, which he views as his primary source of recovery if the owner defaults on the note.

In addition to the owner's home, the note is secured by the property purchased, to justify writing off the entire interest accrued and paid on the loan against income from the property purchased. The home is merely used as **additional security** under a separate trust deed.

The PMI deduction

Also, mortgage insurance premiums, such as for private mortgage insurance (PMI), is tax deductible. Treated the same as interest on a principal residence, a married couple filing a joint tax return with an AGI up to $100,000 (or an individual filing with an AGI up to $50,000) can deduct 100% of the mortgage insurance premiums paid or accrued on property purchased *after January 1, 2007*.

The amount of mortgage insurance premiums deductible is reduced by 10% with each additional $1,000 of AGI over $100,000 for joint filings up to $110,000, and over $50,000 for individuals up to $55,000. Any amounts paid or accrued *after December 31, 2010* or allocable to any period after that time cannot be deducted. [IRC §163(h)(3)(E)]

Chapter 54 Seller financing diminishes tax impact

This chapter discusses the favorable impact installment sale tax reporting has on a carryback seller who finances the sale of his real estate.

Installment sale defers profit reporting

A seller lists his property for sale with his real estate agent. The listing price for the property is $1,500,000 and it is free of encumbrances. The seller's *cost basis* in the property is $100,000.

The seller's goal is to convert his ownership of the real estate into a relatively management-free, interest-bearing investment. The seller is a lifetime investor and is not inclined to turn his real estate over to a trustee or exchange it for an unsecured annuity.

Consistent with his management-free investment goals, the seller is willing to carry back an interest-bearing installment note to provide financing for a buyer. The monthly payments on the note includes interest which will provide the seller with an income, replacing the **net operating income** (NOI) he currently relies on from the property.

The seller's broker locates a buyer for the property . A full listing offer is made consisting of:

- a 20% down payment; and
- a note payable to the seller for the 80% remainder of the purchase price.

The buyer will tender a $300,000 down payment in cash and execute a note in favor of the seller for the balance of the price, secured by a trust deed on the property. The transaction will close prior to the end of the year. The first installment of the carryback note will be paid in the year following the year of the sale.

The terms of the note carried back by the seller will include:

- $1,200,000 in principal;
- 7% interest;
- monthly payments of $7,983.63 on a 30-year amortization; and
- a 10-year due date for a final balloon payment of $1,029,748.

The listing agent reviews a cost analysis of the sale with the seller, noting the net sales price after payment of around $100,000 in closing costs will be approximately $1,400,000. Then, taking the seller's cost basis of $100,000 into account, the listing agent calculates the profit the seller will realize on the sale to be approximately $1,300,000.

When will the seller have to pay taxes on the $1,300,000 in profit taken on the sale of his property?

The seller will **automatically report** the sale as an *installment sale* on his income tax return. The reporting will **defer payment** of a significant amount of profit taxes to later years when installments on the carryback note are received. The portion of the installment which is principal, represents in part the profit received after the year of sale. [Internal Revenue Code §453]

Deferring the tax on profit

For a seller of real estate, *profit* is the portion of the net sales price remaining after deducting the seller's remaining capital investment (**cost basis**) in the property. The formula is: net price minus basis equals profit. However, a developer's dealer property, such as lots or homes sold by a developer, generates ordinary income, not profit.

When a sale of real estate generates profit, called *gain* by the Internal Revenue Service (IRS), **all profit** taken on the sale is reported in the year of sale, unless the profit is:

- *excluded*, which occurs when the sale of property qualifies as a principal residence for the Internal Revenue Code (IRC) §121 $250,000 profit exclusion per individual home owner;
- *exempt*, which occurs on the sale of business or investment property when the net sales proceeds are used to acquire identified replacement property in an IRC §1031 reinvestment plan, or to replace property taken by eminent domain; or
- *deferred*, which occurs when the profit on a sale is allocated to a note carried back on the sale and reported under the IRC §453 installment method.

Applying the profit-to-equity ratio

Before reporting the profit realized on a sale, the **profit is allocated** between the cash proceeds received from the sale and the carryback note.

To accomplish the allocation, a ratio is established between the **profit and the net sale proceeds** from the seller's equity. The percentage of the net sales proceeds which represents profit on the sale sets the ratio, called the *contract ratio* by the Internal Revenue Service (IRS), or the *profit-to-equity ratio*. Thus, whatever percent of the net equity is profit sets the **profit-to-equity ratio** applied to the cash and carryback note received from the sale.

Continuing with our previous example, the **net proceeds** from the seller's equity in the property are $1,400,000, the sales price ($1,500,000) minus any debt relief ($0), minus closing costs ($100,000).

Thus, the percentage of the $1,400,000 **net sales proceeds** represented by the $1,300,000 in profit is 93% (rounded up from .928571), the **contract ratio** or **profit-to-equity ratio**.

Accordingly, 93% of the net cash proceeds received on closing ($200,000) is reported and taxed as **profit** ($185,720) in the year of the sale. In future years, 93% of the principal in each installment paid on the carryback note and received during the year is reported as profit.

Thus, $14,280 of the cash proceeds from the down payment represents the seller's recovery of a portion of his remaining **cost basis** in the property and is not reported as taxable profit, it is a tax-free return of his invested capital.

Each monthly installment on the seller's $1,200,000 carryback note is $7,983.63.

During the year following the year of sale, the 12 installments received by the seller will include $12,189.72 in principal plus $81,613.84 in interest. Additional interest is also paid to the seller to cover any interest that accrued unpaid in the year of the sale.

The seller will report all the interest received as **portfolio category income** without regard for whether the profit is business category or passive category income.

For profit reporting, the profit-to-equity ratio of 93% is applied to the principal in each installment received on the note. Thus, the carryback seller's reportable profit in the first year (following the year of sale) is $11,319.37, 93% of the $12,189.72 in principal payments the seller will receive.

The 7% remainder of the principal he will receive is untaxed — $870.35 — since it represents a partial return of the seller's original capital investment (remaining cost basis).

Ultimately, the final/balloon payment will be received by the seller. Again, the profit-to-equity ratio of 93% will be applied to the final principal payment of $1,029,748.66 ten years after closing. The profit reported by the carryback seller when the final/balloon payment is received will be $956,224.55, 93% of the principal in the balloon payment.

Since the seller acquired the property as a depreciable long-term investment (capital asset) and actually held the property for at least one reporting period, the profit taken by the seller consists of two types of gains:

- *unrecaptured gain* in the amount of all depreciation taken during the seller's ownership (and taxed at a 25% rate); and
- *long-term gain* in the amount of all remaining inflation-appreciation profit (and taxed at a 15% rate).

The goals in an installment sale

While a carryback seller will pay a profit tax on all of the profit in a down payment, final/balloon payment and principal installments, the seller achieves two financial goals on the installment sale of his real estate:

- the **highest sales price** possible by providing the buyer with financing to facilitate the sale; and
- the **maximum annual income** by earning interest on the principal in the carryback note, principal which includes unpaid and deferred profit taxes on 85% of the sale.

When the seller carries back a *straight note* calling for all the principal to be paid in a final/balloon payment after the year of sale, the sale is also reported as an *installment sale*. Here, the one installment is scheduled to be received after the year of the sale. [IRC §453(b)(1)]

However, a **straight note** due in the year of the sale, but paid delinquently, does not qualify the transaction for **installment sale reporting**.

The seller may structure payments on the carryback note so he will receive all or most of his principal (and thus **profit**) in a designated later year (or in any year on demand), if he anticipates taking a substantial loss in that later year which will offset reportable profit on the principal in his carryback note.

Debt relief, profit and taxes

Consider a seller who is solicited by an agent to list his investment real estate for sale. The seller recently refinanced the property, encumbering it with a note which has a principal balance of $480,000.

Sales terms the seller is willing to accept for the sale of the property include:

- a purchase price of $800,000;
- a 20% down payment of $160,000;
- an assumption of the existing $480,000 trust deed loan by the buyer; and
- a carryback note for the balance of the seller's equity, $160,000.

In a discussion with the seller about his profit on the sale, the agent determines the seller's **remaining cost basis** in the property is $50,000, the improvements having been fully depreciated since the seller's purchase of the property in 1985.

On a sale of the property for $800,000, the *net sales price* will be approximately $720,000 after deducting all transactional costs.

The **net sales price**, besides representing the seller's debt and equity, is a return of his $50,000 remaining cost basis and a $670,000 profit on the sale. The profit is a result of depreciation deductions (*unrecaptured gain*) and an increase in the property's dollar value due to inflation and local appreciation (*long-term gain*) during the seller's years of ownership.

All of the **profit** on the sale, unless deferred, exempt or excluded from taxation, will be taxed in the year of sale as either **unrecaptured gain** (depreciation) at a rate of 25%, or as a **long-term capital gain** (increased value) at the current rate of 15%. The federal income tax bill will require around $125,000 to be paid from the net proceeds of the sale plus tax to the state of California, all totaling nearly 25% of the net sale proceeds.

Although the seller does not want to remain responsible for payments on the existing loan, the listing agent suggests the seller reconsider his requirement that a buyer must assume or refinance the existing loan.

The agent explains to the seller how an **assumption or refinancing** of his existing loan by the buyer on an installment sale would produce an adverse tax consequence.

Existing financing and profit

The calculation of profit on a sale is unaffected by the existence or nonexistence of mortgage debt. Debt encumbering a property plays no role in calculating the profit on a sale.

However, the assumption or refinancing of an existing debt by a buyer in a carryback sales transaction plays a huge role in setting the percentage of the down payment and principal in the carryback note which will be reported as profit and taxed each year as payments are received. The *percentage* is the portion of the seller's **net proceeds** from the sale — cash and paper — which is profit on the sale, the profit-to-equity ratio.

Taxwise, the seller's goal in an installment sale is to structure the net sales proceeds (cash and paper) to produce the **lowest profit-to-equity ratio** possible. The lowest percentage possible in any sale is achieved when the net sales price and the net sales proceeds are the same, as in our opening scenario for

this chapter. This percentage occurs naturally when the property is free of debt, unencumbered by liens. Stated another way, there is *no debt relief* on the installment sale.

For the seller to receive the maximum tax deferral benefits available on an installment sale, **no debt relief** can occur. To entirely avoid debt relief when the property sold is encumbered by a trust deed, the seller must **remain responsible** for the trust deed debt after closing the sale. An all-inclusive trust deed (AITD) carryback or land sales contract accomplishes this debt relief avoidance as an installment sale of property since the buyer does not assume or refinance the seller's existing loan.

Here, the principal amount of the carryback note is the balance due on the **purchase price** after deducting the down payment (as occurs with an AITD note), not for the balance of the equity above the down payment (as occurs with a regular trust deed note and a loan assumption or refinance by the buyer).

For example, the greater the amount of the debt assumed (or paid off on the sale) by the buyer, the smaller the seller's net sales proceeds. The profit on the sale does not vary, regardless of how the sale is financed. Thus, the smaller the seller's net proceeds on the sale (cash and carryback note), the higher the percentage of the profit attributable to the net sales proceeds.

When the amount of the mortgage debt assumed or refinanced by the buyer exceeds the seller's remaining cost basis, the amount of the seller's profit will be greater than the seller's net sales proceeds, a situation called *mortgage over basis*. Thus, all principal received on closing the transaction or by installment payments will be profit, and the profit-to-equity ratio will top out the note as 100% profit. [Revenue Regulations §15A.453-1(b)(2)(iii)]

Loan assumption by the buyer

In our previous loan assumption example, 100% of the net proceeds from the down payment and all the principal in the seller's $160,000 carryback note will be profit, taxable in the years the principal amounts are received by the seller. As always, the tax is deferred only on that portion of the $670,000 profit allocated to the principal in the carryback note ($160,000). On the assumption of a loan by a buyer, the amount of the carryback note is a small portion of the total sales price.

The remaining $510,000 in profit not allocated to the carryback note is taxed in the year of sale. Thus, the 25% and 15% profit tax due to the Internal Revenue Service (IRS) on gains (unrecaptured and long-term) in the year the property is sold would be around $105,000 (plus state taxes).

However, the seller's cash sales proceeds are only $80,000, the $160,000 down payment minus the $80,000 in closing costs.

If the carryback seller allows a buyer to assume the existing debt, the immediate financial result will be disastrous since taxes will greatly exceed the seller's cash proceeds. The seller's only relief on an assumption and carryback sale will come from any substantial losses he may incur from other business or investment sources which will offset these profits, and thus reduce his tax liability.

A far more prudent approach exists. The seller can structure the carryback note on the sale of encumbered property as an all-inclusive trust deed (AITD) note for the balance of the purchase price, not just the amount of equity remaining unpaid after the down payment and assumption of the existing loan. With an AITD note, the total amount of the cash down payment and AITD note will equal the *net sales price*, making the AITD note a substantial 80% portion of the sales price. The resulting profit-to-equity ratio will be the lowest percentage figure available for allocation of profit between the cash proceeds and the carryback note.

The all-inclusive trust deed

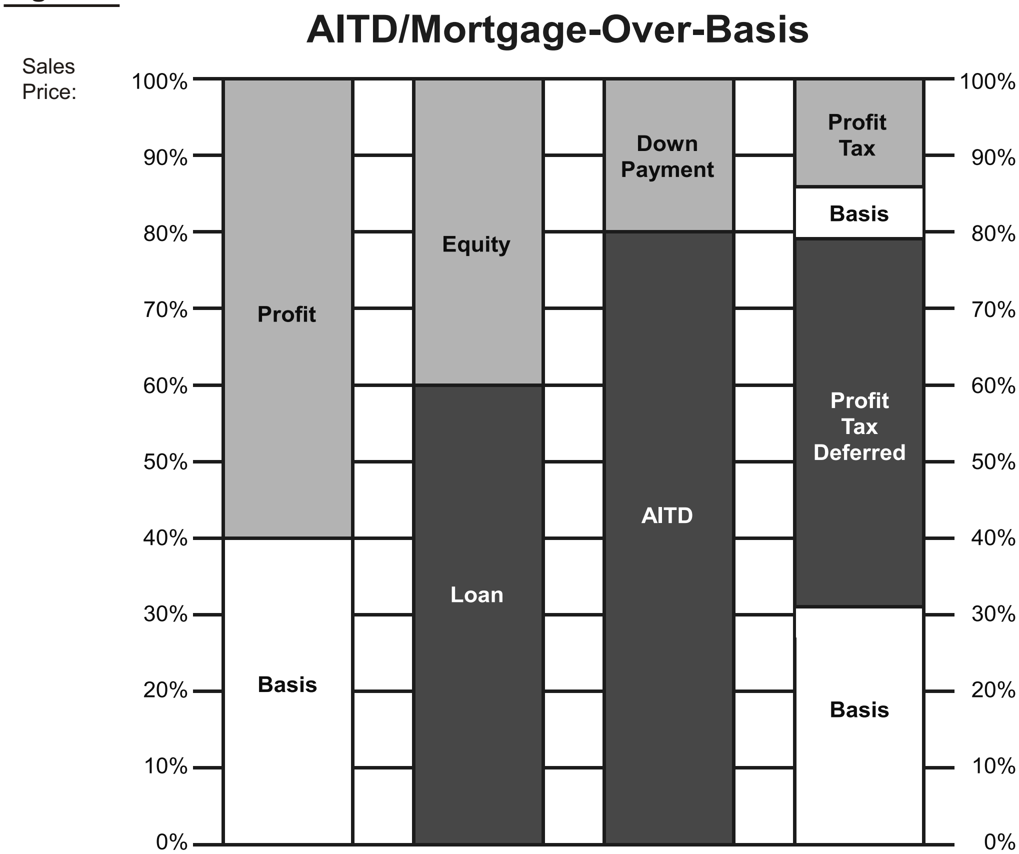
A broker needs to be able to explain to a seller of encumbered property how the carryback of an all-inclusive trust deed (AITD), also called a *wraparound security device*, will:

- reduce the amount of profit allocated to the down payment (and thus reduce the seller's profit taxes in the year of sale); and
- increase the amount of profit allocated to the carryback note (and thus defer to future years the payment of taxes on **all profit** not allocated to the down payment). [See Figure 1]

A necessary arrangement for the seller on the sale of encumbered property is to retain responsibility for all future payments on the trust deed note in order to **avoid debt relief**. To retain responsibility for the loan, the seller must carry back an AITD (or land sales contract) for the **balance of the purchase price** remaining unpaid after the down payment, not a regular note for the balance of his equity after the down payment. Thus, the seller will continue to make payments on the existing loan.

A seller who will remain responsible for a wrapped loan that contains a due-on clause should obtain the **lender's consent** to the carryback sale, called a *reverse assumption*, since the buyer **will not assume** the loan.

Figure 1



The seller may be required to pay an exaction (points and loan modification) to induce the lender to waive the due-on clause and consent to the transfer of title and further encumbrance with the AITD.

Other types of **wraparound financing devices** produce the same tax results as an AITD note. Examples include: land sales contracts, contracts for deed, lease-option sales, and lease-purchase sales agreements. These alternative financing devices also trigger the due-on clause in any trust deed of record (and re-assessment for property taxes), as does any carryback note secured by a trust deed on an encumbered property.

The profit allocated to the AITD note will be sheltered from the payment of profit tax until the seller:

- receives payments of principal on the AITD note;
- hypothecates (pledges) the AITD note; or
- shifts the responsibility for payment of the underlying wrapped loan to the buyer. [**Professional Equities, Inc.** v. **Commissioner** (1987) 89 TC 165]

Continuing with our previous example, the seller's **net sales proceeds** of $720,000 (cash plus the AITD carryback) are the same as the seller's **net sales price** when the seller remains responsible for the existing loan under an AITD carryback.

Since the profit on the sale is $670,000 and the net sales proceeds are $720,000, the profit-to-equity ratio will be 93%, the lowest percentage available on this sales transaction.

In the year of sale, the seller will net $80,000 from the down payment, of which 93% ($74,400) is reportable as profit. All other profit has been allocated to the principal amount of the AITD note. Thus, taxes on all profit not allocated to the down payment are deferred to later years.

The 25% tax on gains from unrecaptured depreciation represented by the $74,400 profit allocated to the down payment is around $18,600. The use of the AITD avoids the $105,000 in taxes the seller would have incurred in the year of sale (as shown before) had the buyer assumed or refinanced the seller's existing loan.

Structuring the carryback sale as an AITD allows the seller to receive **after-tax sales proceeds** of $61,400 from the $80,000 net down payment.

In conclusion, the 93% profit-to-equity ratio will be applied to the principal received in the AITD payments and on the final payoff. The profit-to-equity ratio sets the amount of the profit in the principal on the note which will be taxed when the principal is paid.

AITD later modified to take the profit

Consider a seller who carried back an all-inclusive trust deed (AITD) note on the sale of rental property in a prior tax year. Profit from the sale was allocated to the AITD note, reported and taxed on the installment method.

In the current tax year, the seller sustains either a substantial trade or business loss, or an operating or capital loss in the rental (passive) income category. A portfolio loss on stocks or bonds does not offset the profit taken on a rental property in the passive income category, except for $3,000 annually.

The seller takes no profits this year to offset his loss. The losses, be they business or rental, are of no further tax benefit after the current year since the seller is treated as being in a real estate related business.

However, the seller can shift a portion of the profit from the AITD note into the current year **by negotiating a modification** of the AITD with the buyer. With a modification, the seller can arrange to report a substantial portion of the installment profit in the current year by:

- **shifting responsibility** for the wrapped loan to the buyer by allowing him to assume or refinance the wrapped loan;
- **reducing the principal** balance in the AITD note by the amount of the loan assumed or refinanced by the buyer; or
- **pledge the AITD note as collateral** for a loan of an amount equal to his losses.

The percentage of profit in the principal of the AITD note, as set by the profit-to-equity ratio, is applied to the principal reduction on the AITD note — a reduction equal in amount to the loan assumed or refinanced, or the pledge of the note — to determine the amount of profit to be reported due to the debt relief.

Thus, by **incurring debt relief** by renegotiating the terms of the AITD note and converting it to a regular note, the carryback seller is able to engineer the time for reporting a substantial amount of the profit in his carryback. As a result, the tax on the profit is avoided by the offset provided by the losses from business or rental category operations and sales in the year the AITD is modified.

Pledging carrybacks

A seller who **pledges** his carryback note as collateral for a loan, called *hypothecation*, triggers the reporting of a portion of the profit which was allocated to principal in an amount equal to the amount borrowed. The borrowing and pledging can also be timed to occur in a tax year when a loss on a business or rental activity has occurred, thus offsetting one another. [See **first tuesday** Form 242]

Broker Considerations

When assisting a seller in a carryback sale, the broker should be aware of other tax factors including:

- the **$5 million carryback threshold rule** — a seller who carries back more than $5 million in paper during any one tax year will incur an interest charge on the amount of the deferred tax [IRC §453A];
- **accrual accounting threshold** — if the carryback amount in 2009 is $3,665,500 or more, the seller must use the accrual method of accounting, reporting interest income as it accrues, whether or not payment of interest is actually received [IRC §1274A(c)(2)(A); Rev. Rul. 2008-52]; and
- **minimum interest reporting** — if the carryback amount in 2009 is up to $5,131,700, the interest rate charged must be no less than 9% or the applicable federal rate (AFR). [IRC §1274A(b); Rev. Rul. 2008-52]

If the interest charged on the carryback note is lower than the AFR, the seller must report interest at the AFR rate, called *imputing,* reducing the amount of principal, and thus profit, on the note.

YEAR

2009

Real Estate Withholding Installment Sale Acknowledgement

CALIFORNIA FORM

593-I

(This form can only be completed by the buyer. This is not a remittance document.)

Part I – Buyer's Information **Return this form to your real estate escrow person.**

Name			SSN or ITIN
Spouse's/RDP's Name (if jointly purchased)			Spouse's/RDP's SSN or ITIN (if jointly purchased)
Address (including apt./suite, room, PO Box, or PMB no.)			☐ FEIN ☐ CA Corp no.
City	State	ZIP Code	Daytime telephone number ( )
Property address (if no street address, provide parcel number and county)			

Part II – Seller's Information

Name			SSN or ITIN
Spouse's/RDP's Name (if jointly purchased)			Spouse's/RDP's SSN or ITIN (if jointly owned)
Address (including apt./suite, room, PO Box, or PMB no.)			☐ FEIN ☐ CA Corp no.
City	State	ZIP Code	Installment Withholding Percent ___ ___ . ___ ___% Apply this percent to all installment payments.

Part III – Installment Acknowledgement

Attach to Form 593-I, Real Estate Withholding Installment Sale Acknowledgement, a copy of the signed promissory note. If the seller has elected and certified the Optional Gain on Sale withholding amount, also attach an executed copy of seller's certification of Form 593, Real Estate Withholding Tax Statement, to Form 593-I.

Part IV – Buyer's Acknowledgement to Withhold (Read the "Buyer" information below before you sign.)

I acknowledge that I am required to withhold on the principal portion of each installment payment to the seller for the above shown California real property either at the rate of 3 1/3% of the total sales price or the Optional Gain on Sale withholding percentage, as specified by the seller on Form 593, Real Estate Withholding Tax Statement, of the principal portion of each installment payment. I will complete Form 593 for the principal portion of each installment payment and send one copy of each to the Franchise Tax Board along with the withholding payment, and give one copy of Form 593 to the seller. I will send each withholding payment to the Franchise Tax Board by the 20th day of the month following the month of the installment payment. If the terms of the installment sale, promissory note, or payment schedule change, I will promptly inform the Franchise Tax Board. I understand that the Franchise Tax Board may review relevant escrow documents to ensure withholding compliance. I also understand that I am subject to withholding penalties if I do not withhold on the principal portion of each installment payment and do not send the withholding along with Form 593 to the Franchise Tax Board by the due date, or if I do not send one copy of Form 593 to the seller by the due date.

Buyer's name (if the buyer is not an individual, buyer's agent's name and title) (type or print)______________________________

Buyer's signature ______________________________ Date: ____________

It is unlawful to forge a spouse's/RDP's signature.

Buyer's spouse's/RDP's name (if on title) ______________________________

Buyer's spouse's/RDP's signature (if applicable) ______________________________ Date: ____________

Buyer: Make sure you copy both sides so you will have the instructions for withholding on subsequent payments. Give the original, along with copies of the promissory note and seller's certified Form 593, to your real estate escrow person who should mail them to the Franchise Tax Board. Your real estate escrow person will withhold on the principal portion of the first installment payment. You must withhold on the principal portion of **all** subsequent installment payments (including payoff or balloon payments). Complete Form 593, and mail the documents and payment to the Franchise Tax Board for the principal portion of each installment payment.

Real Estate Escrow Person: Make a copy of this Form for your records. Send the original Form 593-I, a copy of the promissory note, and seller's certified Form 593 to the Franchise Tax Board with the required amount of the first installment payment.

When a seller pledges a carryback note, the **loan proceeds** are considered to be equivalent to the payment of principal on the note. Thus, profit allocated to the principal is reported and taxed in an amount equal to the loan amount. [IRC §453A(d)(1)]

The percentage under the profit-to-equity ratio, used to allocate profit to the carryback note, is applied to the amount of the loan proceeds to determine the amount of profit to be taxed due to the pledge. [IRC §453A(d)(2)]

Prepayment penalties

On the prepayment of a carryback note, the principal paid to satisfy the note includes profit which is reported and taxed in the year of the premature payoff. [IRC §453(c)]

To assure a seller he will retain his tax advantages of an installment sale until the final/balloon payment becomes due, the listing agent will suggest his client include a *prepayment penalty* clause in the carryback note. [See Chapter 9]

*Editor's note — Statutory limits exist for **prepayment penalties** on carryback notes secured by owner-occupied, one-to-four unit residential properties. [Calif. Civil Code §2954.9]*

However, for all other types of property, a prepayment penalty clause may be structured to compensate the seller for the entire amount of the projected profit tax he would prematurely incur due to the prepayment of principal on the note.

The prepayment penalty must be reasonably related to the actual expenditures likely to be made for the payment of profit taxes on a buyer's early payoff, including:

- **profit taxes**, based on current or reasonably anticipated rates; and
- **maintaining a portfolio yield** during the lag time after early payoff and before the funds are re-invested.

Election out

A seller may elect out of installment sale reporting by voluntarily reporting the profit as taxable in the year of the sale. [IRC §453(a), (d)(1)]

Reporting all the profit on a carryback sale as taxable in the year the property was sold (and escrow was closed) may be advantageous to a seller who during the year of sale has an equivalent offsetting factor such as:

- *trade* or *business loss*, on a real estate brokerage or development business;
- *rental operating loss*, directly offset by the profit on a carryback sale of a rental property;
- *rental operating losses* which reduces the seller's adjusted gross income (AGI) if he is in a *real-estate-related business* activity;
- *capital loss* on the sale of a rental or passive business investment; or
- *capital loss* carried forward or from the sale of investment/portfolio category assets (stocks and bonds) when the installment sale is of an investment/portfolio category property, such as the sale of land held for profit on resale, a second home or a triple-net leased, management-free rental property.

California Franchise Tax Board installment sales rules

Unlike the federal withholding scheme, California requires the buyer, through escrow, to withhold 3 1/3% of the sales price from the seller's proceeds on all sales, unless the transaction is excluded from withholding. **Excluded transactions** include sales by all California-based entities and by any individual who **certifies** that the transaction qualifies for an exclusion from withholding for the Franchise Tax Board (FTB).

For individual sellers entering into an installment sale of their property, the transaction is either:

- *qualified* from withholding by the individual seller certifying it is excluded; or
- *not qualified* and subject to the mandatory withholding of the entire 3 1/3% of the price from the down payment, unless the **buyer agrees to withhold** the 3 1/3% from each installment of principal paid on the price. [See Franchise Tax Board Form 593 I accompanying this chapter]

If the buyer refuses to withhold and forward 3 1/3% of the principal in each periodic payment to FTB, the carryback note may call for installments of interest-only payments and avoid amortization of the principal. Thus, only the final/balloon payment would contain a payment of principal. In this fashion, the buyer's agreement to withhold principal would be limited to the final payoff. Then, the buyer would only be responsible for one filing with the FTB, besides the original filing by escrow which withheld 3 1/3% of the cash proceeds from the down payment, not 3 1/3% of the sales price.

However, the sale may **qualify for exclusion** from California FTB withholding. If the sale is excluded, the issue of buyer cooperation to withhold on every payment of principal is eliminated.

The seller's **transaction is excluded** from FTB withholding on both the down payment and the dollar amount of a carryback note, if:

- the property is the seller's **principal residence**;
- the sale is declared by the seller to be a **Internal Revenue Code (IRC) §1031 reinvestment transaction** (with the carryback note being payable to the buyer's trustee for ultimate assignment as consideration for the purchase of a replacement property);
- the property is **sold at a loss** if the purchase price is less than the remaining cost basis; or
- the property is sold for a **price of $100,000** or less.

Miscellaneous installment rules

A carryback note must qualify for installment sale reporting at the time escrow closes. The seller may not restructure a carryback transaction **after escrow closes** in an attempt to qualify the sale as an installment sale by extending the due date on the carryback note from the year of sale to a date beyond the year of the sale. [Revenue Ruling 56-20]

However, the seller may later restructure a carryback note he has reported as an installment sale by modifying its terms, such as extending its due date, subordinating the trust deed to a new trust deed loan, or accepting substitute security from the buyer.

For builders and developers who sell their *dealer property* on a credit sale, installment sale reporting is not available (with exceptions). Their earnings from the sale of inventory are trade/business income, not profit taken on the sale of a capital asset or property actually used to house or conduct the ongoing trade or business operation. [IRC §453(b)(2)(A)]

However, the **dealer property** exclusion does not apply to the installment sale of farms, vacant residential lots and short-term timeshares, even though they may be classified as dealer property. [IRC §453(l)]

No stepped-up basis on death

Consider a wife who, on her husband's death, becomes the owner of her husband's one-half interest in a carryback note they jointly held from an installment sale in a prior tax year. The note was previously carried back on the sale of community property. The carryback note has been reported and taxed on the installment method, thus, the principal of the note contains untaxed profit.

The wife seeks a **stepped-up basis** on the entire note to its market value on the date of her husband's death since the note is a community property asset which she received on her husband's death.

In this scenario, the carryback note held by the community and received by the wife on her husband's death does not qualify for a step-up in basis. The note at the time of death contained profit which had been **realized** on a prior sale and was yet to be taxed as **recognized**. [**Holt** v. **United States** (1997) 39 Fed. Cl. 525]

Chapter 55 Interest reported on a carryback note

This chapter discusses a seller's annual tax reporting of income from a carryback note at no less than a minimum interest rate.

Charge or impute a note's AFR

A seller of real estate extends credit to a buyer for a portion of the property's sales price, evidenced by a note carried back on the sale, called an *installment sale* or *carryback sale*.

In addition to stating the principal amount owed, the note sets forth the interest rate charged by the seller, the monthly payments of principal and interest, and the due date for the final balloon payment.

Taxwise, the **interest income** portion of each payment is reported by the seller as *portfolio category* income. The interest income is then offset by any losses in the operation or sale of portfolio assets, such as land holdings, ground leases, income property subject to management-free, triple-net leases, loans or stocks and bonds. Any remaining interest earnings are reported and, unless offset by losses from the business or rental income categories and personal deductions, taxed at ordinary income rates, ranging from a floor of 10% to a ceiling of 35% (in 2009).

The **principal amount** of the carryback note represents an allocation of part of the **basis** and an allocation of a portion of the **profit** taken on the sale, when the owner's remaining cost basis in the property is a greater amount than the loan encumbering the property.

The cost basis portion of each payment of principal is a *return of capital*, which is not taxed. On the other hand, the profit portion of the principal is comprised of *gains* to be reported within the **property's income category** (trade/business, rental/passive, portfolio or personal residence) and is taxed, if not offset, by other losses.

The **profits** on the sale of income property are typically composed of *unrecaptured depreciation gains* and *long-term capital gains*. These gains, respectively, will be taxed at a ceiling rate of 25% for unrecaptured depreciation gains and 15% for long-term capital gains, unless offset by:

- capital or operating losses on other properties within the same income category;
- allowable losses from other income categories; or
- itemized deductions.

The dynamics of planning

The 133% spread that exists between the long-term capital gain tax (15%) and the maximum tax on interest (35%) is the dynamic which makes tax planning interesting to brokers, attorneys and accountants.

Sellers can reduce the overall amount of their taxes on an installment sale, while still receiving the same total amount of dollars over the life of the installment sale, by:

- increasing the purchase price of the property sold (thus increasing profits which are taxed at a 15% rate); and

- decreasing the interest rate charged on a carryback note (thus reducing ordinary income which is taxed at higher rates than gains).

To combat this shift in earnings from interest to profits on installment sales, which reduces the overall tax on the entire transaction, the federal government set a floor rate for **minimum interest reporting** on carryback notes. Minimum interest rates limit the extent to which taxes can be reduced, properly called *tax avoidance*.

Conceptually, all sums received by the seller on the carryback note, whether labeled as principal or interest, are subject to a **reallocation of principal to interest** under *imputed interest reporting* rules.

The **rules for imputing** only apply to the seller. The **buyer reports** the principal and the interest as agreed in the carryback note, and the terms of the note remain unaltered by any imputing reported by the seller.

Reallocation of principal

Carryback financing arrangements are subject to the minimum imputed interest rate reporting rules if the terms of the note call for any payments to be due more than six months after the date the transaction closes.

Every debt that is the result of an extension of credit on a sale, such as a note carried back by a seller, has an **Applicable Federal Rate (AFR)** of interest. The note's AFR sets the minimum rate of interest the seller can report over the life of the carryback note. The rate of interest reported is fixed and does not vary during the life of the note, unless the terms of the note are modified.

Figure 1

Example Applicable Federal Rates

June 2009

Short term, not over 3 years:	**AFR**
Monthly	0.75%
Quarterly	0.75%
Semi-annual	0.75%
Annual	0.75%
Medium term, between 3 and 9 years:	**AFR**
Monthly	2.03%
Quarterly	2.03%
Semi-annual	2.04%
Annual	2.05%
Long term, over 9 years:	**AFR**
Monthly	4.20%
Quarterly	4.22%
Semi-annual	4.24%
Annual	4.28%

Each carryback debt and security device, such as a trust deed note, land sales contract, lease-option sale or a lease-purchase agreement, has its own AFR. These security devices used by the seller include the terms for payment of the installment debt owed the seller for the unpaid portion of the purchase price.

Any carryback debt negotiated at an interest rate lower than the note's AFR triggers the reporting of a portion of the note's principal balance as interest. AFR reporting entails an allocation and conversion of principal to interest by the taxpayer, called *imputing*. [Internal Revenue Code §1274(b)]

Taxwise, **imputing decreases** the amount of principal reported on the carryback note. In effect, imputing also reduces the sales price the seller reports for the property sold. Likewise, the **profit** which would have been reported without imputing is decreased. Further, the **interest income** is increased by the amount of principal allocated to interest. [See Figure 1]

The financial result of this shift of funds from profits to interest income is an overall increase in the amount of taxes the seller will pay on the transaction.

The buyer is completely unaffected by the imputing and the seller's income tax reporting.

Applicable Federal Rates

Figures for the Applicable Federal Rates (AFRs) are set monthly by the Internal Revenue Service (IRS). AFR figures are loosely based on the rates of return (yield) on Treasury notes and bills issued by the government.

The figure setting the AFR for a particular carryback note is selected based on three factors, including:

- the **acceptance date** of the purchase agreement;
- the **term of the note**; and
- the note's periodic **payment schedule**.

The first step towards identifying the proper AFR for a note is to locate the AFRs for the **month of acceptance** of the purchase agreement or counteroffer, lease-option or land sales contract. Alternatively, the AFR figure may be selected from the AFRs for either of the two months preceding the date the purchase agreement is accepted. [IRC §1274(d)(2)]

The IRS sets 12 fixed-rate AFRs each month. Thus, based on the **note's due date**, the fixed rates are broken down into **three AFR categories**: short-, medium-and long-term. Further, each category contains four rates, classified as monthly, quarterly, semi-annual and annual **periodic payment schedules**, one of which is selected based on the payment schedule in the carryback note. [See Figure 2]

The second step towards identifying the proper AFR for a note is to select the AFR category in which the note belongs, based on the **term of the note**. The selection of a category is set by the number of years from the closing of the sale to the due date of the note's final payment. The categories are divided as follows:

- notes with due dates of **three years or less** fall into the **short-term** AFR category;
- notes due between **three and nine years** fall into the **medium-term** AFR category; and
- notes due in **over nine years** fall into the **long-term** AFR category. [IRC §1274(d)(1)(A)]

Option periods to renew or extend the note's due date are included when figuring the length of the note's term and selecting the correct AFR category. [IRC §1274(d)(3)]

Figure 2

Reamortization of imputed interest

- ✓ $1,000,000 note at 7% annual interest rate, AFR is 8%
- ✓ $665.30 monthly payments
- ✓ five-year due date
- ✓ Total payments collected equal $134,049.59; $7,983.63 annually in the first years plus $94,131.59 final payment

Principle reduction

Term	7% note balance	8% AFR balance
origination	$100,000	$95,994
end of year 1	98,984	95,678
year 2	97, 895	95,377
year 3	96,727	94,966
year 4	95,475	94,566
Final payoff	**94,131.59**	**94,131.59**

The last step towards identifying the proper AFR for a note is to select the rate within the due date category that matches the note's periodic **payment schedule** (monthly, quarterly, etc.).

9% ceiling up to threshold amount

For all carryback sales entered into in 2009, in an amount no greater than $5,131,700, called the interest threshold, the minimum reportable interest rate is the lesser of 9% or the note's Applicable Federal Rate (AFR). [Revenue Ruling 2003-119]

Thus, 9% compounded semi-annually is the **maximum rate** for imputing carryback notes with a principal balance at or below the threshold amount, even though the AFR may exceed 9% (as it did in the early 1980s). [IRC §1274; Rev. Rul. 2003-119]

The threshold amount for applying the 9% ceiling is **adjusted for inflation** each year by the Internal Revenue Service (IRS), starting from a base amount of $2,933,200 in 1990. [IRC §1274A(d)(2)]

A carryback note with a principal amount greater than the interest threshold must report interest at or above the note's AFR on the entire amount on the note, without regard to the ceiling of 9% and not just on the amount exceeding the threshold. In summary, if the note rate is less than the note's AFR, the principal amount of the note (for reporting only) is reduced to conform to the amortization schedule, due date and the note's AFR, a process which is called *imputing*.

All carryback notes that are part of the same transaction or a series of **related transactions** are considered to have occurred in one sale. The amounts to be paid in principal and interest over the life of all carryback notes in related sales transactions are totaled to determine whether the 9% threshold ceiling or the AFR restrictions apply. [IRC §1274A(d)(1)]

Reamortize and report

The Internal Revenue Service (IRS), in pursuit of a higher tax revenue, introduces an equalizer in the form of a minimum annual **rate of interest** the seller will report on a carryback note. This floor rate for reporting interest income neutralizes the seller's ability to effectively raise the price a buyer will pay in exchange for reducing the interest charges on the carryback note. Thus, the minimum reportable interest rate implicitly affects the maximum sales price of property.

Now consider a seller who agrees in a purchase agreement to carry a note for $100,000 at an interest rate of 7%, payable $665.30 monthly with a $94,131.77 final/balloon payment due in five years. Based on the month the purchase agreement is entered into by all parties, the carryback note's medium-term due date and the monthly principal and interest payment schedule, the fixed Applicable Federal Rate (AFR) which controls for the entire life of the note is 8%, a higher rate than the 7% note rate.

Over the life of the note, the seller is scheduled to receive a total stream of principal and interest payments equal to $134,049.59 — $100,000 in principal and just over $34,000 in interest under the terms of the 7% note.

Each year, the seller will receive principal and interest payments of $7,983.63 which he must first apply to and report as interest at no less than the note's AFR. The amount of the remaining payment is then deducted from the note's principal balance.

The principal received is further broken down into basis and profit on the profit-to-equity ratio for installment sale reporting of profit taxable from year to year. [IRC §453]

Taxwise, the interest rate the buyer is charged is less than the AFR. Thus, interest income is imputed at the AFR figure for the seller's tax reporting. To **calculate the interest** income reported to the IRS, the seller must reamortize the note (based on the amount of the scheduled installments, the final/balloon payment amount and the numbers of months until due) at 8%, which is the note's AFR. These figures will set the amount imputed as interest which in turn reduces the principal amount reported on the note.

This re-analysis of the principal and interest in the note's stream of scheduled installments and payoff amounts at the imputed interest rate **reduces the profit** by reducing the original principal amount of the note and the principal amount contained in each payment. Conversely, a larger portion of each payment than originally agreed to in the note is reported as interest income. [See Figure 1]

Commingling interest and profit

Profits reported on the sale of real estate are taxed at rates ranging from 10% to 25% for various types of *gains* on real estate sales.

Ordinary income is taxed at higher rates than profits, ranging from 10% up to 35%, which sets the rates for taxes paid on interest income.

The objective of imputed interest reporting is to prevent carryback sellers from structuring the price and terms of payment to convert interest income into profit (**gains**) and achieve up to a 60% reduction in taxes on the amount converted to profits over the life of the note.

For example, a carryback seller of rental property compensates for his increased sales price by negotiating a reduced interest rate on his carryback note, resulting in a zero-sum difference in the amount of dollars he will receive over the life of the note. The remaining rentals he owns are highly leveraged and produce annual operating losses.

The interest income will not directly offset the rental operating losses (since it is portfolio category income, not passive rental category income). However, if the seller is classified as being in a real estate related business, he can offset the interest income by the rental losses.

Taxwise, the high sales price generates excessive profits as principal payments are received from year to year on the note. Thus, the large annual reportable operating losses from the seller's highly leveraged rental properties will annually offset the excess profit from the installment sale of a rental which will be reported each year in the passive income category.

Unless the seller can write off the operating losses as resulting from real-estate-related business, the losses will not offset interest income since interest is reported in a separate income category.

The seller will use his annual reportable rental operating losses to shelter his artificial profit received annually on the installment sale of the rental property at an above market price.

The monthly payments received by the seller equals the same amount he would receive in monthly payments on a lesser purchase price with a higher interest rate.

Here, compulsory reporting of imputed interest at minimum rates prevents sellers who are not in a real-estate-related business from commingling investment category interest income with rental category operating losses to offset one another and neutralize taxes. [IRC §469(c), (e)]

Interestingly, no reporting rules exist to govern the opposite process by which the seller reduces the purchase price and, by the terms of the carryback note, converts profit into increased interest earnings. This process would increase portfolio category income (in order to, for example, eat up losses carried forward on stock sales and carrying costs of land ownership).

Consider a "land-poor" seller who has built up substantial investment/portfolio category losses carrying his property. The seller sells his rental category property (with a $1,000,000 fair market value) in the passive income category for $750,000 with a $100,000 down payment.

The seller carries back the balance in an all-inclusive note (AITD) for $650,000 at 15% — significantly above current market interest rates — with a seven year due date. To ensure his high yield for seven years on the note will effectively recover the dollar amount of the $250,000 price reduction, the seller includes a lock-in clause in the note which bars prepayment for seven years.

In case the note is legally payable at any time during the seven year period, a stiff prepayment penalty of 30% on unscheduled principal payments is included to cover the shortfall in total receipts from the sale (interest for seven years) due to an early payoff.

Thus, the seller has effectively converted $250,000 of his profit on the sale of rental property into investment category interest income on the carryback note. A portion of his actual rental profit (converted to interest) is now sheltered by his accumulated investment/portfolio losses carried forward from prior years due to land ownership expenses (or stock market losses).

Threshold for accrual reporting

If the principal amount of a note carried back in 2009 is more than $5,131,700, labeled the *accrual threshold*, the seller must report interest income each year **as the interest accrues** without regard for when payments on the note are received. [Rev. Rul. 2003-119]

For example, a carryback note with a principal amount of $10,000,000 calls for a **graduated interest rate** of:

- 5% the first year;
- 6% the second;
- 7% the third;
- 8% the fourth;
- 9% the fifth; and
- 10% in years six through eight with a **final/balloon payment** due on the eighth anniversary of closing.

The amortization period for the payments is 30 years, with principal and interest payable monthly. Each year the amount of the payment increases as the note is reamortized at that year's graduated rate for the remainder of the amortization period.

To determine if additional interest income will be imputed, one must first establish the amount of the **average annual interest** earned during the eight-year term of the note. To do so, interest earned on the accrual basis must be calculated as a constant (average) annual yield over the eight-year term, taking into account all interest agreed to be paid on the note in the future.

The average **rate of interest** over the eight year period is 8.12%. However, the average interest rate charged is not equalevent to **interest paid**, called the *yield*. The rate of interest is constant over the years of the note while the *amount* of interest paid is reduced each year as the principal balance declines due to amortization. As a result of amortization, the average yield (or interest paid) is 7.75% over the eight-year life of the note. Accrual-threshold notes, such as the $10,000,000 note, are controlled by **accrual reporting**. Thus, the carryback seller reports interest annually at the note's constant **average yield** (in this case 7.75%) over the full term of the note.

In the graduated payment example, this leads the seller to report more interest income than he actually receives in the early years of the note, and less interest income than he actually receives in the later years under the terms of the note.

Additionally, if the average yield on the accrual-reporting note is less than the note's Applicable Federal Rate (AFR), the seller must report interest at the AFR each year.

The straight note

The fundamental difference between annual accrual reporting and cash reporting is best demonstrated by considering a carryback note with principal and interest due in one installment payable after the year of sale, sometimes called a *straight note* or *sleeper trust deed*.

First consider a carryback note for $1,000,000, at 5% interest compounded annually, with principal and interest due in two years. The note's short-term Applicable Federal Rate (AFR) is 7%, compounded semi-annually.

In this example, the seller is entitled to report his profit and interest income from the **straight note** on the **cash method** when he receives the principal. The straight note does not exceed the threshold amount which would require accrual accounting rather than cash accounting. A statement is filed with the seller's tax return in the year of the sale which states that no interest will be reported until the loan is paid in full. [Revenue Regulations §1.1274A-1]

The seller receives $1,102,500 of principal and interest in a final/balloon payment on the due date of the straight note. However, rather than reporting the 5% interest income of $102,500 as stated in the note, the seller must report the interest at the note's AFR. Thus, he will report $140,000 (rather than $102,500) as interest income. The remaining $962,500 of the payment (rather than $1,000,000) is principal which represents profit and a return of capital in amounts based on the equity-to-profit ratio for the original installment sale transaction.

Now consider a carryback **sleeper trust deed** note for $10,000,000, a principal amount that exceeds the accrual threshold and requires annual (accrual) reporting of interest.

The $10,000,000 sleeper trust deed note calls for 5% interest, compounded annually, with a two-year due date for the payment of all principal and interest. The note's short-term AFR is 7%, compounded semi-annually.

The principal amount of the note is first recomputed to impute interest at the note's AFR. Once the principal amount is recomputed, the seller's reportable principal in the note is no longer $10,000,000, but slightly over $9,600,000. Thus, like cash reporting, accrual reporting includes additional interest income of approximately $400,000 **imputed as interest** over the two year period, which reduces the note's principal amount (and profit on the sale).

However, unlike cash reporting, accrual reporting requires interest to be reported annually at the note's AFR, as it **accrues unpaid**.

As a result, nearly $700,000 is reported as portfolio category interest income in the first year, even though the seller receives no payment with which to pay the taxes on the accrued interest income.

Special imputed interest rates and exemptions

Interest on **sale-leaseback financing** arrangements is imputed at 110% of the note's Applicable Federal Rate (AFR). [IRC §1274(e)]

Carryback notes created on the sale of land between **family members** will impute interest at a ceiling rate of no more than 6%, compounded semi-annually, unless the total sales price of all transactions between the same two family members in the same year exceeds $500,000 (the threshold which triggers imputed interest reporting at the note's AFR). [IRC §483(e)]

The following carryback notes are exempt from imputed interest reporting:

- carryback notes with a due date of six months or less [IRC §1274(c)(1)(B)]; and
- notes with a principal amount less than $3,000. [IRC §483(d)(2)]

A carryback note assumed by a buyer does not receive a new AFR at the time of assumption, unless the terms of the note are modified. [IRC §1274(c)(4)]